PAPER – 10

CORPORATE ACCOUNTING & AUDITING (CAA)

CMA INTERMEDIATE

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CA Inter Dec-21

AIR 49



Ria Gupta
CA Inter May-22

What Our Students have to Say....

Aman Mahajan (CA AIR 19)

I really liked your classes, especially the practical linkages explained with amazing graphics. The full subject test serieshelped a lot in improving my writing speed and presentation skills.

Sundar Sri Renganathan B (AIR 33)

I took Accounting from IndigoLearn and the classes were really good. They emphasized on conceptual clarity over getting things done quickly, which is really vital to score good marks in practical papers. Other resources like Notes, Quizzes and Forum was beneficial too.

Dwarakesh

Thank you IndigoLearn team for the guidance and support throughout the past few months. I had great conceptual clarity in all the subjects and the revision classes by Suraj Sir were very helpful. Study planner and Free resources were very useful. Thank you Team IndigoLearn.

Yug Manoj Kumar Bhattad

I have cleared my CA Foundation examination with the total of 286. And this was not possible without the efforts and support of IndigoLearn. The way of teaching with utmost conceptual clarity is the best thing at Indigolearn.

Prakash Bhatt

Superb, one stop solution for All CA and Accountancy students they serve real Education at very very reasonable price

Naveen Kumar S

Good experience, unlimited views helped a lot in last one month preparation. Looking forward for

Bhagyasree Chougule

It was only because of Indigolearn that my concepts became very clear, and I was able to crack the exam. I wasn't 100% prepared I needed more practice but luckily I got through. I'm definitely choosing IndigoLearn for group 2 preparation. A big thanks!

Mohd Thayyab

Theoretical subjects made easier through story based examples and charts. Concept clarity 100%. Fully exam+practical oriented classes will help not only to retain the concepts during exams but for the longer duration.

Lalit Chetan Sanpal

Indigolearn has been fantastic and brilliant. Helped me alot in my preparations. I cleared both the groups in first attempt with your brilliant classes and notes. Thanks to all the faculties, coordinators, forum admins and everyone at Indigolearn. Really grateful. Will go for CA Finals at Indigolearn For sure. Thank you so much Indigolearn.

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Abishek M

I'd like to thank IndigoLearn for all the support they've provided me with. Modules were great. They were time saving and straight to the point. I extensively used the materials provided before exams, they were so helpful. Also I'd appreciate them for providing unlimited views as I kept looking into the maths modules till the end.

Munnur Nandini Sree

Accounting classes I have taken from IndigoLearn. Now I feel that it's a great choice that I have made (after seeing my result) because only in Accounting I got exemption. Thank you IndigoLearn.

Harshita G

Thank u so much IndigoLearn for your guidance. This is only possible because of u people.... For my finals also my journey will continue with IndigoLearn.

Bharathsha PS

I purchased Economics, IT, FM, EIS and Audit from Indigolearn. All your classes are superb and anyone can easily crack the CA exams. What makes u special is your classes help us to understand the concepts very well.Special thanks to the FM faculty, I studied only 2 chapters in economics,and still managed to score excemption in the 8th paper.

Nayi Mihir kumar

This platform is very helpful in all activity like mcq practise, notes, teaching activities, revisions and the forum interaction with all students which I like the most. If anybody want to clear their exams in first attempt then IndigoLearn is the best platform for them. My all regards to IndigoLearn. Thank you so much.

Rajalaxmi
CA Inter

Can't believe I cleared.Sathya Sir, Suraj Sir, Yogita Mam ... thanks to all my faculties. Basically an Eng student with zero accounts knowledge. Thanks IndigoLearn for making me clear in first attempt.

Priyanka Udeshi

All the faculties have excellent knowledge of the subject and deliver it in very crisp & effective manner. Also, quick response at Forums never let any of my doubts go unresolved no matter how small they were. Thank you once again to all the teachers & staff at IndigoLearn!

Naveen Kumar T

It been a great journey with indigo learn team. Thanks to all the facilities and forum friends who support me a lot.

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Chapter – 1 ACCOUNTING OF SHARES & DEBENTURES

UNIT 1 – INTRODUCTION TO COMPANY ACCOUNTS

Unit-1 INTRODUCTION

TYPES OF COMPANIES



Ownership	• Government • Foreign • Private • Public
Size	• One Person • Small
Listing (on Stock Exchange)	• Listed • Unlisted
Liability	• Limited by Guarantee • Limited by Shares • Unlimited
Holding	• Holding • Subsidiary

Prepraration of Financial Statements	Balance Sheet
	Statement of Profit & Loss
	Cash Flow Statement
	Notes to Accounts

INTRODUCTION

COMPANY

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

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

Shareholders are authorised by law to elect a board of directors

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

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2. SALIENT FEATURES

Incorporated Association – Invisible/ Intangible / Existing only in the eyes of law

A company comes into existence only through registration under Companies Act. It is regarded as an **artificial legal person**.

Separate Legal Entity

A company **can contract, sue and be sued in its incorporated name** and capacity.

Perpetual Existence

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

Common Seal

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

Limited Liability

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

Distinction between ownership and management

Ownership – Shareholders;

Management: Board of Directors, appointed by the shareholders

- Why 'Company' form of organisation?

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

3. TYPES OF COMPANIES

1. **Government Company** - Section 2(45) of the Companies Act, 2013
   - Any Company in which **not less than fifty-one per cent of the paid-up share capital** is held by
     - the Central Government, or
     - any State Government or Governments, or
     - partly by the Central Government and partly by one or more State Governments,
   - and **includes** a company which is a **subsidiary company of such a Government company**.

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

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

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

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

A company which by its articles,

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

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

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

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

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

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

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

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

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

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

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

8. **Unlisted Company**

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

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

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

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10. **Company limited by Guarantee -** Section 2(21) of the Companies Act, 2013
    Liability of its members **limited by the memorandum to such amount as the members may respectively undertake to contribute** to the assets of the company in the event of its being wound up.
11. **Unlimited Company -** Section 2 (92) of the Companies Act, 2013
    A company **not having any limit on the liability of its members**.

12. **Holding Company -** Section 2 (46) of the Companies Act, 2103
    A company of which one or more other companies companies are subsidiary companies.

13. **Subsidiary Company** - Section 2(87) of the Companies Act, 2013
    - A company in which the holding company:
        - **Controls** the **composition of the Board of Directors** (i.e. power to appoint or remove all or a majority of the directors); or
        - **Exercises or controls > ½** of the **total share capital** either on its
            - own or
            - together with one or more of its subsidiary companies.
    - **Deemed Subsidiary Company** - indirect control through the subsidiary company (ies).

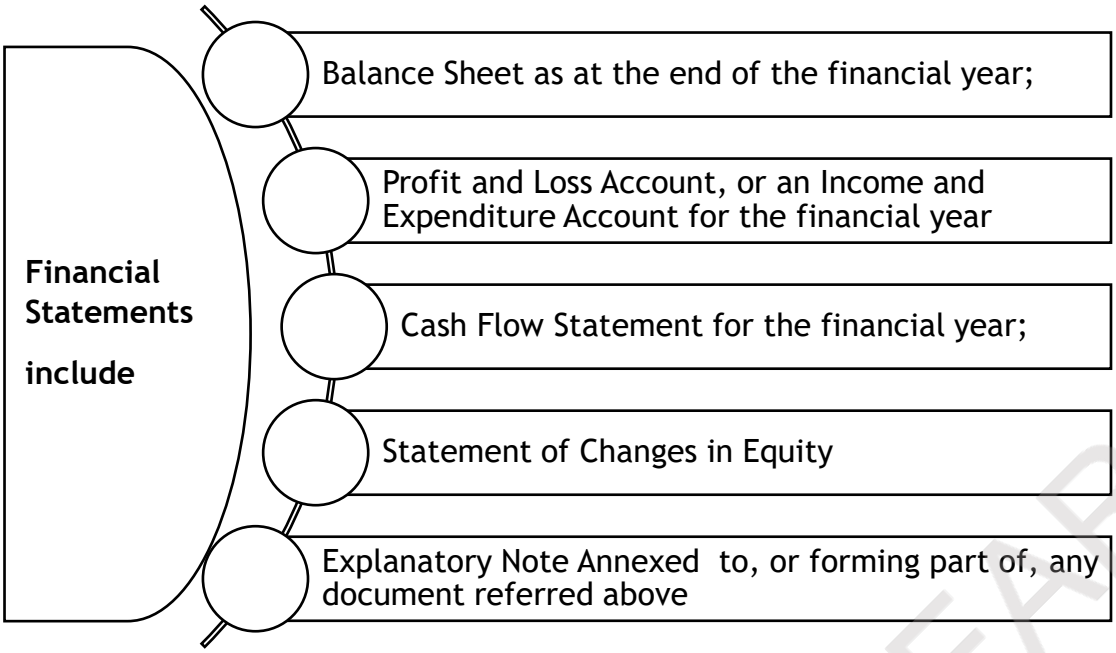
4. MAINTENANCE OF BOOKS OF ACCOUNTS – Section 128

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

5. PREPARATION OF FINANCIAL STATEMENTS

Requisites of Financial Statements (Section 129)
- Give a **true and fair view of the state of affairs** of the company or companies
- **Comply** with the **notified accounting standards**
- Format
    i. If specific Act is applicable (Eg: Insurance Company, Banking company, etc.) – as given in the respective statute
    ii. **Schedule III of the Companies Act, 2013**
        - Part I: Balance Sheet
        - Part II: Profit & Loss Account
- Board of Directors of the company shall **lay financial statements at every annual general meeting of a company**
- W**hat are Financial Statements?** (Section 2(40) of the Companies Act, 2013)

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Part I – Form of Balance Sheet

Name of the Company.....

Balance Sheet as at.....

(Rs.in...)

	Particulars	Notes No.	Current Year	Previous Year
	EQUITY AND LIABILITIES			
1.	**Shareholders' funds**			
	a. Share capital (A)			
	b. Reserves and Surplus (B)			
	c. Money received against share warrants			
2.	**Share application money pending**			
3.	**allotment**			
	Non-current liabilities			
	a. Long-term borrowings (C)			
	b. Deferred tax liabilities (Net)			
	c. Other long-term liabilities			
4.	d. Long-term provisions (D)			
	Current liabilities			
	a. Short-term borrowings (E)			
	b. Trade Payables			
	▪ Total outstanding dues to micro enterprises and small enterprises			
	▪ Total outstanding dues to creditors other than micro enterprises and small enterprises			
	c. Other current liabilities (F)			
	d. Short-term provisions			
1	**Total**			

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2	**ASSESTS** **Non-current assets** a. Property, Plant and Equipment i. Tangible assets (G) ii. Intangible assets (H) iii. Capital Work-in-progress iv. Intangible assets under development b. Non-current investments (I) c. Deferred tax assets (Net) d. Long-term loans and advances (J) e. Other non-current assets **Current assets** a. Current investments (K) b. Inventories (L) c. Trade receivables d. Cash and cash equivalents (M) e. Short-term loans and advances f. Other current assets **Total**			

<u>Balance Sheet items to be explained in the Explanatory Note</u>:

A. **SHARE CAPITAL** – for each class

- Authorised share capital - Number and amount.
- Issued; Subscribed & Fully paid; and Issued subscribed but not fully paid.
- The par value per share.
- Reconciliation of Shares outstanding
  - at the beginning &
  - at the end of the reporting period
- Calls unpaid
- Forfeited shares

B. **RESERVES AND SURPLUS –** subheads (Additions and deductions since last balance sheet to be shown under each of the specified heads)

- Capital Reserves
- Capital Redemption Reserve (CRR)
- Securities Premium
- Debenture Redemption Reserve.
- Revaluation Reserve
- Surplus (the balance as per Profit and Loss statement)
- Other Reserves (specify the nature and purpose)

C. **LONG TERM BORROWINGS** - subheads

- Bonds/Debentures
- Term loans
  - From Banks
  - From Other parties
- Deferred payment liabilities
- Deposits
- Long term maturities of finance lease obligations
- Loans and advances from related parties

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- Other loans and advances (specify nature)

D. **OTHER LONG-TERM LIABILITIES**

(a) Trade payables;

(b) Others.

E. **LONG TERM PROVISIONS**

- Provision for Employee Benefits (eg: gratuity, provident fund etc.)
- Other provisions (specify the nature)

F. **SHORT TERM BORROWINGS**

- Loans repayable on demand
  - From banks
  - From other parties
- Loans and advances from related parties
- Deposits
- Other loans and advances (specify the nature)

FA. **TRADE PAYABLES -** Outstanding dues to Micro, Small and Medium Enterprises

- Principal amount and interest due thereon remaining
- Amount of interest paid
- Amount of interest due and payable for period of delay
- Amount of interest accrued and remaining unpaid

G. **OTHER CURRENT LIABILITIES**

- Current maturities of long-term debt
- Current maturities of finance lease obligations
- Interest accrued but not/and due on borrowings
- Income received in advance
- Unpaid dividends
- Application money received for allotment of securities and due for refund and interest accrued thereon
- Unpaid matured deposits and interest accrued thereon
- Unpaid matured debentures and interest accrued thereon
- Other current liabilities (specify the nature)

H. **SHORT TERM PROVISIONS**

- Provision for Employee Benefits
- Other provisions (specify the nature)
-

I **TANGIBLE ASSETS -** Classification

- Land
- Buildings
- Plant and Equipment
- Furniture and Fixtures
- Vehicles
- Office equipment
- Others (specify nature)

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J. **INTANGIBLE ASSETS**

- Goodwill
- Brands /trademarks
- Computer software
- Mastheads and publishing titles
- Mining rights
- Copyrights, and patents and other intellectual property rights, services and operating rights
- Recipes, formulae, models, designs and prototypes
- Licenses and franchise
- Others (specify nature)

K. **NON-CURRENT INVESTMENTS** (Classify as Trade & Other Investments)

- Investment property;
- Investments in Equity Instruments;
- Investments in preference shares;
- Investments in Government or trust securities;
- Investments in debentures or bonds;
- Investments in Mutual Funds;
- Investments in partnership firms;
- Other non-current investments (specify nature)

L. **LONG TERM LOANS AND ADVANCES**

- Long-term loans and advances shall be classified as:
  - Capital Advances;
  - Security Deposits;
  - Loans and advances to related parties (giving details thereof);
  - Other loans and advances (specify nature).
- The above shall also be separately sub-classified as:
  - Secured, considered good;
  - Unsecured, considered good;
  - Doubtful.

M. **OTHER NON-CURRENT ASSETS**

- Long-term Trade Receivables (including trade receivables on deferred credit terms);
- Others (specify nature);

Long term Trade Receivables, shall be sub-classified as:

- Secured, considered good;
- Unsecured, considered good;
- Doubtful.

N. **CURRENT INVESTMENTS**

- Investments in Equity Instruments
- Investment in Preference Shares
- Investments in Government or Trust Securities
- Investments in Debentures or Bonds
- Investments in Mutual Funds
- Investments in Partnership Firms
- Other investments (specify nature)

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O. **INVENTORIES**

- Raw materials
- Work-in-progress
- Finished goods
- Stock-in-trade (in respect of goods acquired for trading)
- Stores and spares
- Loose tools
- Goods in transit
- Others (specify nature)

P. **TRADE RECEIVABLES**

- Secured, considered good
- Unsecured, considered good
- Doubtful

Aggregate amount of Trade Receivables outstanding for a period exceeding six months from the date they are due for payment should be separately stated.

Q. CASH AND CASH EQUIVALENTS

- Balances with banks
- Cheques, drafts on hand
- Cash on hand
- Others (specify nature)

R. **SHORT TERM LOANS AND ADVANCES**

- Loans and advances to related parties (giving details thereof);
- Others (specify nature).

The above shall also be sub-classified as:
(a) Secured, considered good;
(b) Unsecured, considered good;
(c) Doubtful.

S. **OTHER CURRENT ASSETS** – Specify nature

T. **CONTINGENT LIABILITIES AND COMMITMENTS**

- **Contingent liabilities**
  - Claims against the company not acknowledged as debt;
  - Guarantees;
  - Other money for which the company is contingently liable.
- **Commitments**
  - Estimated amounts of contracts remaining to be executed on capital account and not provided for;
  - Uncalled liability on shares and other investments partly paid;
  - Other commitments (specify nature).

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PART II – Form of STATEMENT OF PROFIT AND LOSS

Name of the Company.....

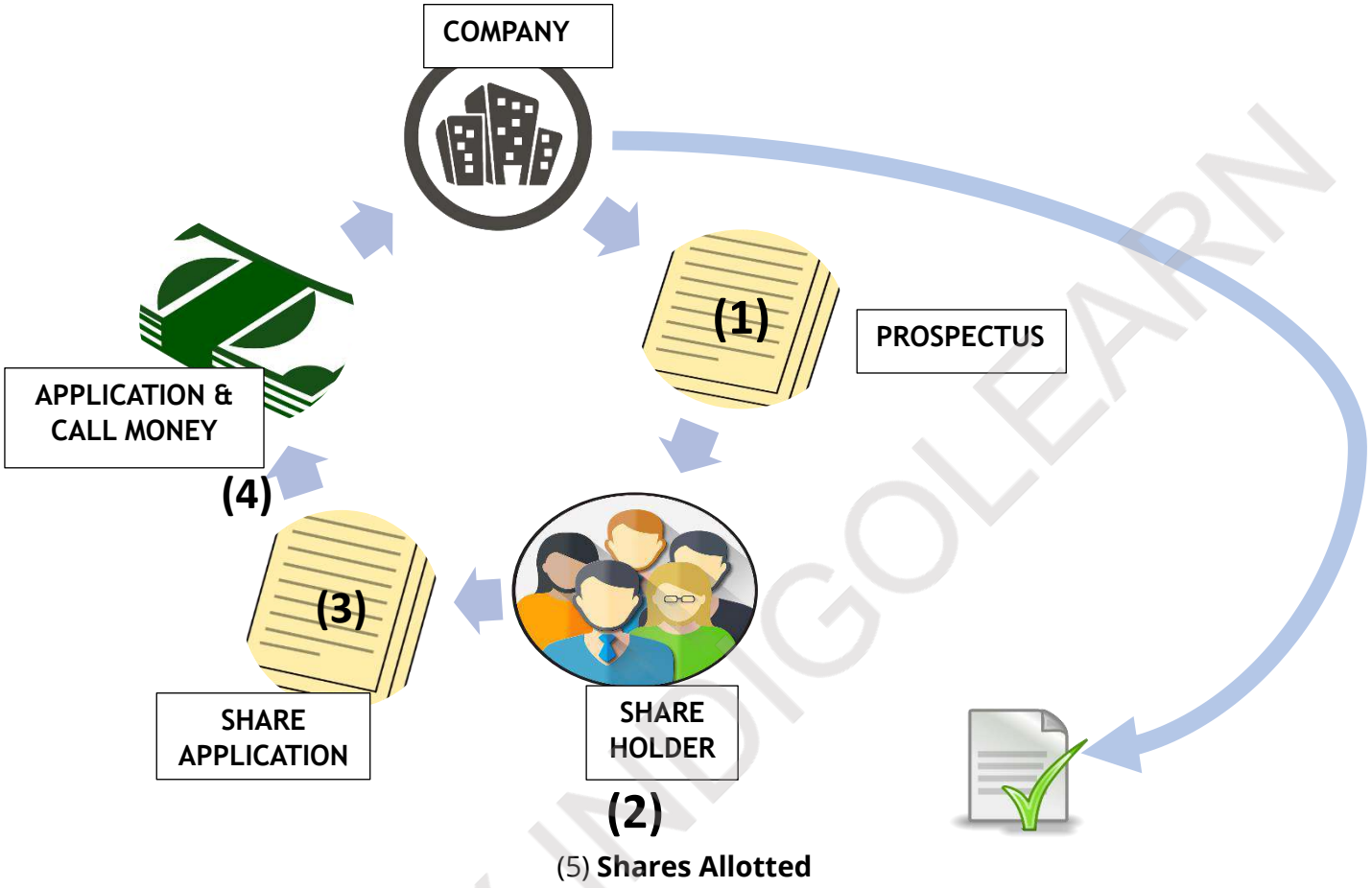
Profit and Loss Statement for the year ended .....

(Rs.in.....)

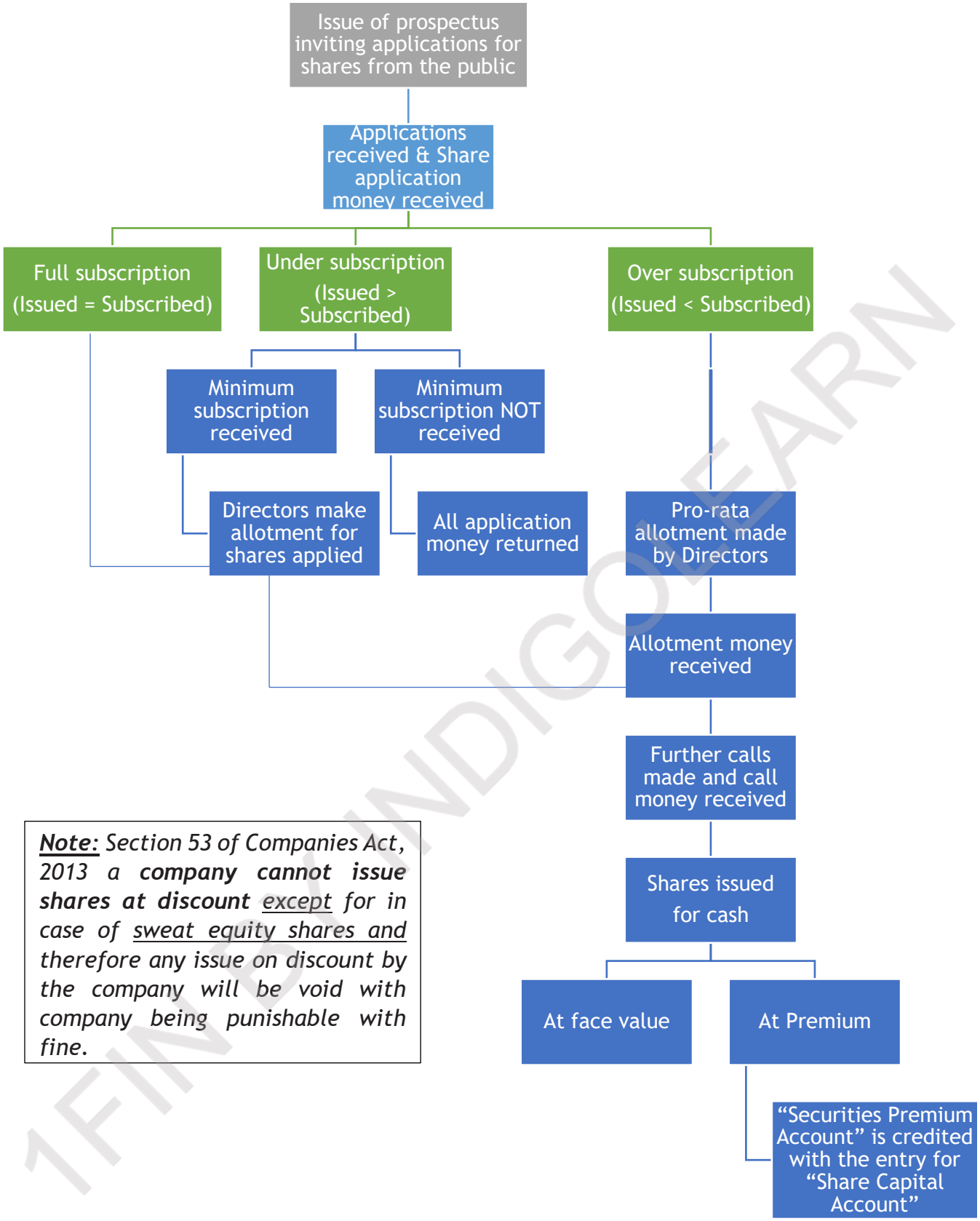
	Particulars	Note No.	Figures for the current reporting period		Figures for the previous reporting period	
I.	Revenue from operations			xxx		xxx
II.	Other income			xxx		xxx
III.	Total Revenue (I + II)			xxx		xxx
IV.	Expenses:			xxx		xxx
	Cost of materials consumed			xxx		xxx
	Purchases of Stock-in-Trade			xxx		xxx
	Changes in inventories of finished goods Work-in- Progress and Stock-in-Trade			xxx		xxx
	Employee benefits expense			xxx		xxx
	Finance costs			xxx		xxx
	Depreciation and amortization expense			xxx		xxx
	Other expenses			xxx		xxx
Total expenses				xxx		xxx
V. Profit before exceptional and extraordinary items and tax (III-IV)				xxx		xxx
VI. Exceptional items				xxx		xxx
VII. Profit before extraordinary items and tax (V-VI)				xxx		xxx
VIII. Extraordinary Items				xxx		xxx
IX. Profit before tax (VII-VIII)				xxx		xxx
X. Tax expense:						
	(1) Current tax		xxx		xxx	
	(2) Deferred tax		xxx	xxx	xxx	xxx
XI. Profit (Loss) for the period from continuing operations (VII-VIII)				xxx		xxx
XII. Profit/(Loss) from discontinuing operations				xxx		xxx
XIII. Tax expense of discontinuing operations				xxx		Xxx
XIV.	Profit/(Loss) from discontinuing operations (after tax) (XII-XIII)			xxx		xxx
XV.	Profit (Loss) for the period (XI + XIV)			xxx		xxx
XVI.	Earnings per equity share:					
	(1) Basic			xxx		xxx
	(2) Diluted			xxx		xxx

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Procedure for raising funds through equity



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

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INTRODUCTION

Capital

Funds provided by the owners.

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

SHARE CAPITAL

- **Share**

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

- **Face / Nominal Value of Share**

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

- **Share Price**

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

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

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

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SHARE CAPITAL - Categories

Authorised Share Capital or Nominal Capital	*Issued Share Capital*	*Subscribed Share Capital*
•It is the maximum limit of capital which a company is authorised to raise during its lifetime •It is mentioned in 'Capital Clause' of the "Memorandum of Association" •It is disclosed on the face of the Balance Sheet at face value	•It is the portion of the authorised capital issued by the company •It includes the nominal value of shares issued for •Cash •Consideration other than Cash to • Promoters • Others •The remaining portion of the Authorised Share capital which is not issued either in cash or consideration may be termed as **'Un-issued Capital'**	•It is part of Issued Share Capital •subscribed by the public •allotted by the company •It also includes face value of shares issued by company for consideration other than cash.

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SHARE CAPITAL - Categories

Called-up Share Capital

- It is the portion of the issue price of shares which a company has demanded or called from shareholders
- The balance, which the company has decided to demand in future may be referred to as Uncalled Capital."

Paid-up Share Capital

- It is the portion of called up capital which is paid by the shareholders.
- A particular amount called by the company and not paid by the shareholder(s), fully or partially, is known as **'unpaid calls'** or **'installments (or Calls) in Arrears'**
- Paid up Capital = Called up Capital - Installments in Arrears
- In balance sheet, Called -up and Paid-up share capital are shown in together

Subscribed Share Capital

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

Reserve Share capital

- It is the portion of the uncalled capital which a company has decided to call only in case of liquidation of the company
- As per Section 65 of the Companies Act, 2013, a Company may decide by passing a resolution

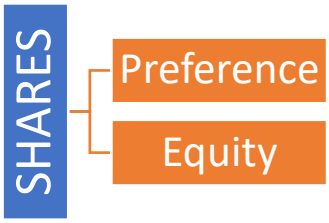
1. Authorised Capital = Issued Capital + Unissued Capital.
2. Subscribed Capital differs based on subscription type
   - **Fully Subscribed:** Subscribed Capital = Issued Capital
   - **Over Subscribed:** Subscribed Capital > Issued Capital
   - **Under Subscribed:** Subscribed Capital < Issued Capital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

- **Calls in advance**

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

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Types of Shares

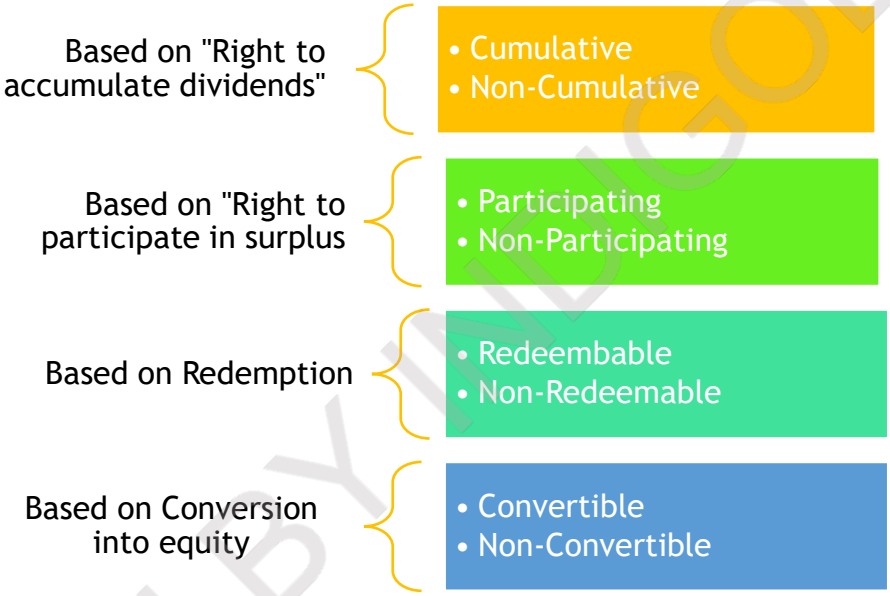


- **Preference Shares**

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

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

- **Type of Preference Shares**



a. **Cumulative Preference Shares**

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

b. **Non-cumulative Preference Shares:**

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

c. **Participating Preference Shares**

- These shares give the right to participate in the surplus profits, if any, after the equity shareholders

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- Every year for dividend at a stipulated rate
- At the time of winding up for distribution of profits (a pre-determined proportion)

d. Non-participating Preference Shares

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

e. Redeemable Preference Shares

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

f. Non-redeemable Preference Shares

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

g. Convertible Preference Shares

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

h. Non-convertible Preference Shares

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

Special Points related to Preference Shares:

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

- **Equity Shares**

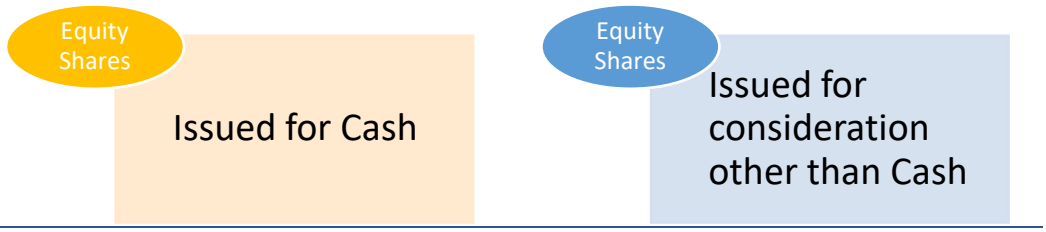
Those shares, which are not preference shares are called Equity Shares.

Special Points for Equity Shares

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

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Types of Equity Shares



ISSUE OF SHARES FOR CASH

Private Companies

- Private Placement

Public Companies

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

❖ Minimum Subscription

A public limited company cannot make any allotment of shares unless

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

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

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

Guidelines of the Securities Exchange Board of India (SEBI)

- ➢ **Minimum subscription** to be received in an issue shall **not be less than 90%** of the offer through offer document.

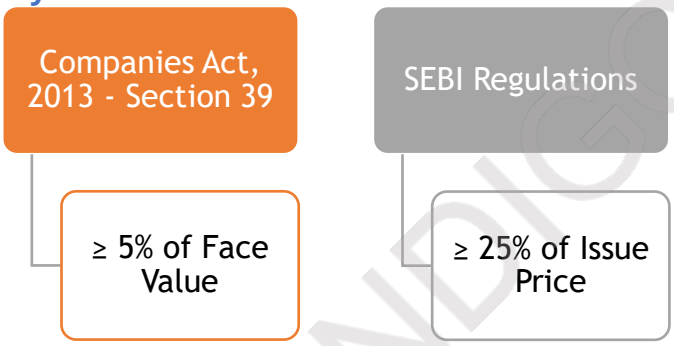
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- **Non receipt of the minimum subscription of 90%** of the issue, all application moneys received shall be refunded:
  - Non-underwritten Issue – within 15 days of the closure of the issue; and
  - Underwritten Issue – within 7 days of the closure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

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

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

Application money



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

SUBSCRIPTION OF SHARES

❖ Full Subscription

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

❖ Under Subscription

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

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

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

❖ Over Subscription

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

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

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JOURNAL ENTRIES – ISSUE OF SHARES

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

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	(Being money received on allotment)			
Call being made	Share Call A/c Dr.	xxx		Amount due on the call
	To Share Capital A/c		xxx	
	(Being share call made due at Rs……)			
Receipt of Call Money	Bank A/c Dr.	xxxx		Amount called actually received
	To Share Call A/c		xxxx	
	(Being share call money received)			

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

SHARES ISSUED AT DISCOUNT

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

Discount = Nominal Value – Issue Price

Example:

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

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

SHARES ISSUED AT PREMIUM

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

Premium = Issue Price -Nominal Value

Example:

Nominal Value (a)	Issue Price (b)	Premium (Rs.) (c) = (b-a)	Premium % (d)= [(c) ÷ (a)]100
100	100	0	N.A
100	120	20	20%
100	90	N.A	N.A
250	350	100	40%

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

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❖ *Securities Premium Account*

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

❖ Utilisation of Securities Premium Account

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

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

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

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

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

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

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

JOURNAL ENTRIES – ISSUE OF SHARES AT PREMIUM

(1) Premium amount called with Application Money

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

(2) Premium amount called with Allotment Money

Event	**Entry**	**Debit (Rs.)**	**Credit (Rs.)**	**Remarks**
Receipt of Application Money	Bank A/c Dr.	xxxx		Total application money + Premium amount
	To Share Application A/c		xxxxx	Actual amount received.

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

OVER SUBSCRIPTION AND PRO-RATA ALLOTMENT

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

Reasons for oversubscription

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

Allotment for oversubscription

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

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Example

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

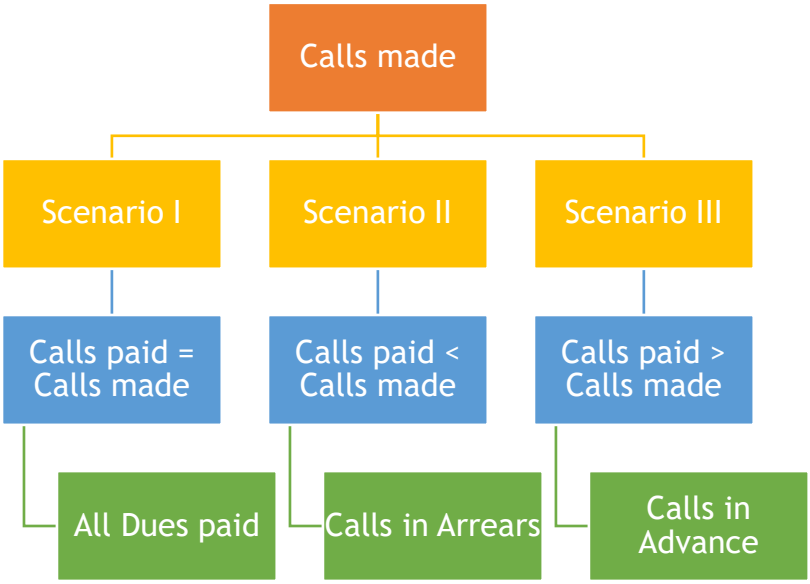
- ✓ Excess amount received is treated as an advance against allotment and calls and thereby adjusted against the amount due on allotment or calls.
- ✓ Surplus money after making adjustment against future calls is returned to the applicants.
- ✓ The applicants are informed about the allotment procedure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

JOURNAL ENTRIES – OVER SUBSCRIPTION (PRO-RATA ALLOTMENT)

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

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CALLS IN ADVANCE & CALLS IN ARREARS



❖ **Calls in Arrears**

➢ The total unpaid amount on one or more instalments called but shareholder failed to pay is known as *Calls-in-Arrears* or *Unpaid Calls*.

➢ It is the uncollected amount of capital from the shareholders;

➢ It is shown by way of deduction from 'called-up capital' to arrive at paid-up value of the share capital.

❖ **Calls in Advance**

➢ Amount not yet called up but paid by shareholders is known as Calls-in-advance.

➢ Interest at a rate not exceeding 12 % p.a. is to be paid on such advance call money.

➢ This amount is credited in Calls-in-Advance Account and shown separately under Current Liabilities

❖ **Interest on Calls in Arrears & Calls in Advance**

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

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JOURNAL ENTRIES – CALLS IN ADVANCE & CALLS IN ARREARS

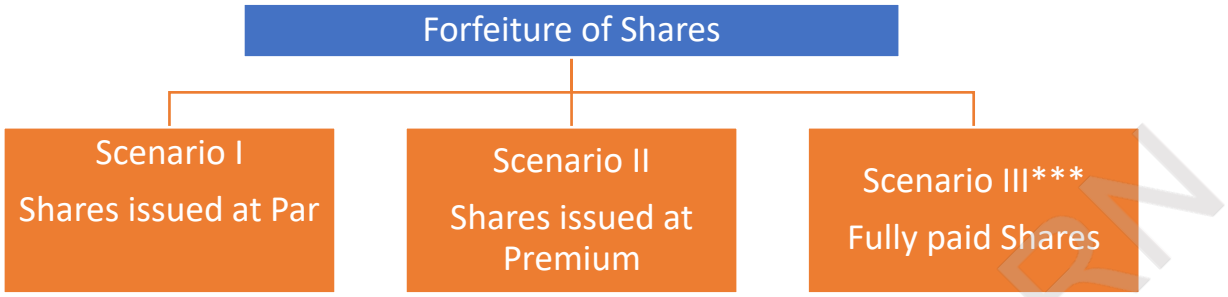
Event	Entry	Debit (Rs.)	Credit (Rs.)	Remarks
(1a) Calls in Arrears after call made	Calls in arrears A/c Dr.	xx		Amount of Unpaid Calls
	Bank A/c Dr.	xxxx		Amount received
	To Share Allotment A/c		xxx	Total allotment money due
	To Share Calls A/c		xxxx	Total allotment money due
	(Being call money/ allotment money received on .... shares at ` per share.)			
(1b) Calls in Arrears received	Bank A/c Dr.	xx		Amount of Unpaid calls received
	To Calls in Arrears A/c		xx	
	(Being unpaid calls received)			
(2a) Calls in Advance received	Bank A/c Dr.	xxx		Call amount received in advance
	To Calls in Advance A/c		xxx	
	(Being excess application money received)			
(2b) Call made	Calls in Advance A/c Dr.	xxx		Call amount received in advance
	Bank A/c Dr.	xx		Remaining call money received, if any
	To Particulars Call A/c		xxxx	Call money due
	(Being call in advance adjusted and call money due received)			
(3a)For interest receivable on Calls-in-Arrears	Shareholder's A/c Dr.	xxx		
	To Interest on Calls in arrears A/c		xxx	
	(Being interest on calls in arrears at the rate of ____% due)			
(3b) For receipt of interest	Bank A/c Dr.	xxx		
	To Shareholder's A/c		Xxx	
	(Being interest money received)			
(4a) For interest payable on Calls-in-Advance due	Interest on Calls-in-AdvanceA/c Dr.	xxx		Amount of interest due for payment
	To Shareholder's A/c		xxx	
	(Being interest on calls in advance due)			
(4b) For payment of interest	Shareholder's A/c Dr.	xxx		Amount of interest paid
	To Bank A/c		xxx	
	(Being interest money received)			

FORFEITURE OF SHARES

- Forfeiture of shares is the action taken by a company to cancel the shares, WHEN shareholders fail to pay their allotment and/or calls on the due dates
- The directors are usually empowered by the Articles of Association to forfeit those shares by strictly following the rules and regulations in the Articles of Association

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- Proper notice to the defaulting shareholder(s) should be served.
- Directors also have the right to cancel such forfeiture before the forfeited shares are re-allotted.
- When shares are forfeited, the title of such shareholder is extinguished but the amount paid to date is not refunded to him.
- The shareholder then has no further claim on the company.



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

JOURNAL ENTRIES – FORFEITURE OF SHARES

Important Amounts to consider:

(i) Amount **called-up (i.e., amount credited to capital)** in respect of forfeited shares.
(ii) Amount already **received** in respect of those shares.
(iii) Amount **due but has not been received** in respect of those shares.

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

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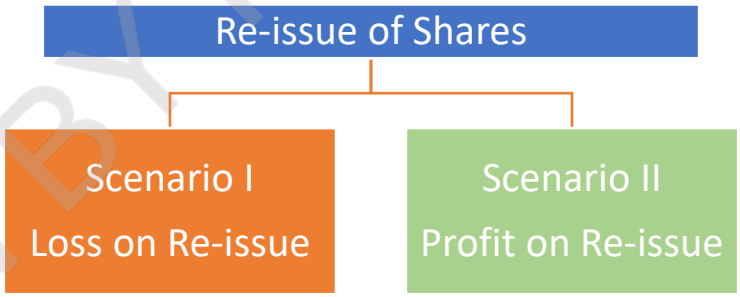
Premium NOT received	To Forfeited Shares A/c		xxx	Amount already received on forfeited shares
	To Share Allotment A/c		xxx	IF amount due but not paid
	To Share Call A/c		xx	IF amount due but not paid
***(2a) Forfeiture of shares issued at Premium –** IF Premium received*	Share Capital A/c Dr.	xxx		Call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

RE-ISSUE OF FORFEITURE OF SHARES

✓ A forfeited share is merely a share available to the company for sale and remains vested in the company as an obligation to dispose it off.

✓ Reissue of forfeited shares is not allotment of shares but only a sale. In practice, forfeited shares are disposed off, by auction.

✓ These shares can be re-issued at any price so long as the total amount received (from the original allottee and the second purchaser) for those shares is not less than the amount in "Calls-in-arrears" on those shares.



❖ Important Points

➢ Loss on re-issue should not exceed the forfeited amount.

➢ When the shares are re-issued at a loss, such loss is to be debited to "Forfeited Shares Account".

➢ If the loss on re-issue is less than the total amount forfeited, the surplus should be transferred to Capital Reserve.

➢ When only a portion of the forfeited shares are re-issued, then the profit made on re-issue of such portion of shares only must be transferred to Capital Reserve.

➢ If the shares are re-issued at a price which is more than the face value of the shares, the excess amount will be credited to Securities Premium Account.

➢ The forfeited amount on shares (amount originally paid-up) not yet reissued should be shown under the heading 'share capital.'

➢ If the re-issued amount and forfeited amount (taken together) exceeds the face value of the

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shares re-issued, it is not necessary to transfer such amount to Securities Premium Account.

- The credit balance of forfeited shares account cannot be considered a surplus until the shares forfeited have been re-issued, because the company may, on re-issue, allow the discount to the new purchaser equivalent to the amount held in credit in this regard in the forfeited shares Account

❖ Calculation of Profit on Re-issue of Forfeited Shares

Example

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

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

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

JOURNAL ENTRIES – FORFEITURE OF SHARES

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

ISSUE OF SHARES FOR CONSIDERATION OTHER THAN CASH

- A public limited company generally, issue their shares for cash but it may issue shares

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- in a **direct exchange** for land, buildings or other **assets**.
- **in payment for services rendered** by promoters, lawyers in the formation of the company.

➢ These shares should be **shown separately under 'Share Capital'**.

➢ Within specified time of allotment, the **company must produce before the Registrar** a **written contract of sale of service** in respect of which shares have been allotted.

When assets are purchased in exchange of shares

Assets Account Dr.
To Share Capital Account

Illustrations

Question: 1

JHP Limited is a company with an authorised share capital of Rs.10,00,000 in equity shares of Rs.10 each, of which 6,00,000 shares had been issued and fully paid on 30th June 2016. The company proposed to make a further issue of 1,00,000 of these Rs.10 shares at a price of Rs.14 each, the arrangements for payment being:

a. Rs.2 per share payable on application, to be received by 1st July 2016;
b. Allotment to be made on 10th July 2016 and a further Rs.5 per share (including the premium) to be payable;
c. The final call for the balance to be made, and the money received by 30th April 2017.

Applications were received for 3,55,000 shares and were dealt with as follows:

i. Applicants for 5,000 shares received allotment in full;
ii. Applicants for 30,000 shares received an allotment of one share for every two applied for; no money was returned to these applicants, the surplus on application being used to reduce the amount due on allotment;
iii. Applicants for 3,20,000 shares received an allotment of one share for every four applied for; the money due on allotment was retained by the company, the excess being returned to the applicants; and
iv. the money due on final call was received on the due date.

You are required these transaction (including cash items) in the Journal of JHP Ltd.

Question: 2

A company had an authorised capital of Rs.10,00,000 divided into 1,00,000 equity shares of Rs.10 each. It decided to issue 60,000 shares for subscription and received applications for 70,000 shares. It allotted 60,000 shares and rejected remaining applications. Up to 31-3 -2017, it has demanded or called Rs.9 per share. All shareholders have duly paid the amount called, except one shareholder, holding 5,000 shares who has paid only Rs.7 per share.

Prepare a balance sheet assuming there are no other details.

Question: 3

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

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

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

Question: 4
On 1st April 2017, A Ltd. issued 43,000 shares of Rs. 100 each payable as follows:
- Rs.20 on application;
- Rs.30 on allotment;
- Rs.25 on 1st October 2017; and
- Rs. 25 on 1st February 2018

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

Question: 5
Pant Ltd. invited applications for 50,000 equity shares at Rs.50 each, which are payable as on application Rs.20, on allotment Rs.10 and on first and final call Rs.20. The company received applications for 60,000 shares. The directors accepted application for 50,000 shares and rejected the rest.
Show Journal entries if company refunded the application money to rejected applicants and allotment money was received for 45,000 shares.

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UNIT 3 : ACCOUNTING FOR BONUS ISSUE AND RIGHT ISSUE

1.BONUS ISSUE

1.1 Introduction

- Issue of additional shares to existing shareholders, free of cost in proportion to existing holding
- It is also known as 'capitalization of profit' or ' scrip issue' or ' capitalization of profits'.

EXAMPLE:

Alpha company announced bonus issue to its shareholders in the ratio of 2:3 (2 shares for 3 shares held)

Shareholder X has 6000 shares before announcement.

He will be entitled to 4000 bonus shares (6000 shares *2/3)

1.2 Provisions of Companies Act 2013

As per section 63 (1) a company can issue fully paid up bonus issue to members, in any manner out of

- Free reserves
- Securities premium account
- Capital redemption reserve account

Provided that no issue shall be made out of

- Capital reserve
- Revaluation reserve

1.2.1 Conditions for bonus issue – Sec 63(2)

a) authorised by **articles of association**
b) on the recommendation of the board, must be authorised in the **general meeting**
c) not defaulted in the **payment of interest or principal** in respect of fixed assets, deposits or debt securities
d) not defaulted in the payment of **statutory dues of employees** (gratuity, provident fund, bonus)
e) outstanding partly paid-up shares made **fully paid-up**

SEBI Regulation 293

Includes above points +

Any of its promoters or directors is not an economic fugitive offender

Note: While converting partly paid up shares into fully paid up,

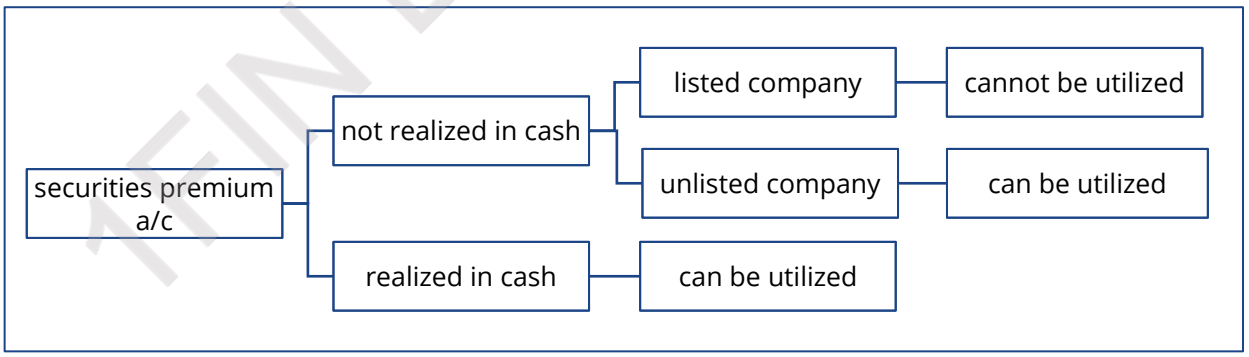
Free reserve	Can be used
Securities premium a/c	Cannot be used
Capital redemption reserve a/c	Cannot be used

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1.3. Journal entries

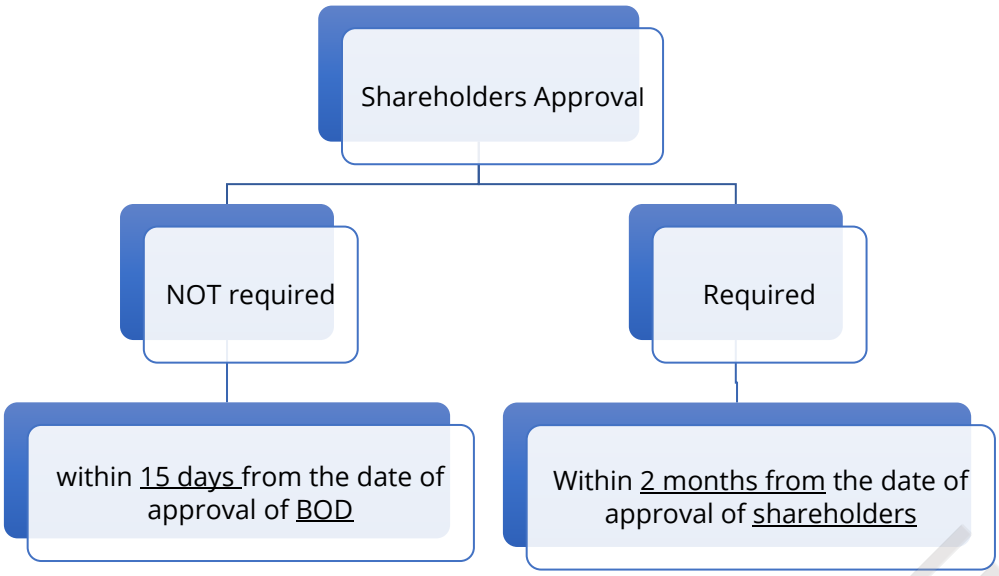
s. n	Particulars		Debit	Credit
(A) 1.	**Sanction of an issue of bonus shares**			
	Capital redemption reserve a/c	Dr		
	General reserve a/c	Dr		
	Profit and loss a/c	Dr		
	To bonus to shareholders a/c			
2.	**Issue of bonus shares**			
	Bonus to shareholders a/c	Dr		
	To share capital a/c			
(B) 1.	**Sanction of bonus by converting partly paid up shares into fully paid up shares**			
	General reserve a/c	Dr		
	Profit and loss a/c	Dr		
	To bonus to shareholders a/c			
2.	**On making final call due**			
	Share final call a/c	Dr		
	To share capital a/c			
3.	**On adjustment of final call**			
	Bonus to shareholders a/c	Dr		
	To share final call a/c			

Note: Balance in the securities premium for issue of bonus shares, utilized in the following manner



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Regulation 295 – Completion of a bonus issue



1.5. EFFECTS OF BONUS ISSUE

Bonus issue has following major effects:

- **Increase in share capital**
- **Reduction in earnings per share (EPS) and other per share values**
- **Favourable act considered by the market**
- **Adjustment in market price**
- **Reduction in accumulated profit**

2.RIGHT ISSUE

2.1 Introduction

The companies act, 2013 provides existing shareholders a right to subscribe to any fresh issue of shares by the company in proportion to their existing holding for shares.

If the shareholders are not willing to exercise the rights, they are given right to renounce it in favour of someone else (unless the Articles of the company prohibits)

2.2. Conditions for Rights Issue of Shares

As per section 62(1)(a) of Companies Act 2013, the shares to existing equity shareholders through a letter of offer subject to the following conditions, namely:

A. The offer made by notice,
   - Specifying the number of shares offered,
   - Limiting a time not being less than 15 days and not exceeding 30 days from the date of offer

B. The offer shall include a right exercisable by the person concerned to renounce his shares offered; and the notice shall contain a statement of this right

C. Board of directors shall dispose the notice, after the expiry of specified time

2.3. Exceptions to the rights of existing equity shareholders

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As per section 62, rights shares can be offered, without being offered to existing shareholders under following situations, provided company has passed special resolution.

To employees under employees stock option

To any persons, either for cash or consideration, (Price of the shares is determined by registered valuer)

To creditors or debenture holders, as an option to buy equity shares

To government for converting the debentures or loan into equity shares

2.4. Right of renunciation

It refers to the right of the shareholder to surrender his right to buy the securities and transfer such rights to any other person

The monetized value available to equity shareholders due to right issue is known as 'value of right'

$$\text{Ex right value of shares} = \frac{\text{Cum-right value of existing shares} + (\text{Rights shares} * \text{Issue price})}{\text{Existing number of shares} + \text{number of rights shares}}$$

Value of right = cum right value of share - ex right value of the shares

2.5. Journal Entries

S.N	PARTICULARS	DEBIT	CREDIT
1	**Issue of right shares at par**		
	Bank a/c Dr		
	To equity share capital a/c		
	(Being issue of right shares at par)		
2	**Issue of right shares at premium**		
	In case rights shares are being offered at a premium,		
	the premium amount credited to securities premium a/c		
	Bank a/c Dr		
	To equity share capital a/c		
	To securities premium a/c		
	(being issue of right shares at premium)		

2.6. EFFECTS OF RIGHT ISSUE

- Maintenance of existing shareholders' proportional holding in company and retain their financial governance rights
- Dilution in the value of share

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- Image enhancement
- Convenience in handling issue.

Summary

- Bonus issue means an issue of additional shares free of cost to existing shareholders
- Bonus shares can be issued from following:
    1. Free Reserves
    2. Securities Premium
    3. Capital Redemption Reserve
- Bonus issue cannot be made out of revaluation reserve created by revaluation of assets
- A Right issue is an offer of equity shares in a further issue of shares by a company to its existing shareholders, for maintaining their financial and governance interest in the company.
- The right shares are offered at a price less than cum - right value of shares, causing dilution in its post - right issue.
- The value of share offered after right is termed as ex- right value of shares (average price)
- The right issue is cost effectiveness as compared to a full-blown public issue.
- However, the dilution in the value of the share is a dampener and a major limitation in case of right issue.

Illustrations

Illustration – 1

Following items appear in the trial balance of Bharat Ltd. (listed company) as on 31st March, 20X1:

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

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

Solution: Illustration 1

Journal Entries

Particulars		Dr. (₹)	Cr. (₹)
Capital **Redemption** Reserve A/c	Dr.	55,000	
Securities Premium A/c	Dr.	30,000	
General Reserve A/c (b.f.)	Dr.	15,000	
To Bonus to Shareholders A/c			1,00,000
(Being Bonus issue of one share for every four shares held)			
Bonus to Shareholders A/c	Dr.	1,00,000	

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To Equity Share Capital A/c			1,00,000
(Being Bonus shares allotted or Capitalisation of profit)			

Working Note:

Number of Bonus shares to be issued- (40,000 shares / 4) X 1 = 10,000 shares

Value of Bonus shares = 10,000 shares of ₹10 each = ₹1,00,000

Illustration – 2

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

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

On 1st April, 20X1 the Company has made final call @ Rs. 2 each on 90,000 equity shares. The call money was received by 20th April, 20X1.
Thereafter the company decided to capitalize its reserves by way of bonus at the rate of one share for every four shares held. Show necessary entries in the books of the company and prepare the extract of the Balance Sheet immediately after bonus issue if the company has passed necessary resolution at its general body meeting for increasing the authorized capital.

Solution: Illustration 2

Journal Entries in books of Solid Ltd.

Particulars			**Dr. (₹)**	**Cr. (₹)**
20X1				
April 1	Equity Share Final Call A/c	Dr.	1,80,000	
	To Equity Share Capital A/c			1,80,000
	(Final call of ₹2 per share on 90,000 equity shares due as per Board's Resolution dated ...)			

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April 20	Bank A/c	Dr.	1,80,000	
	To Equity Share Final Call A/c			1,80,000
	(Being Final Call Amount Received)			
April 20	Securities Premium A/c	Dr.	20,000	
	General Reserve A/c	Dr.	1,60,000	
	Profit and Loss A/c (b.f.)	Dr.	45,000	
	To Bonus to Shareholders A/c (Bonus issue @ 1 share for every 4 shares held by utilising various reserves as per Board's Resolution dated...)			2,25,000
April 20	Bonus to Shareholders A/c	Dr.	2,25,000	
	To Equity Share Capital A/c			2,25,000
	(Capitalisation of profit)			

Balance Sheet (Extract) as at 30th April, 20X1 (after bonus issue)

Particulars	Notes	Amount (₹)
I. Equity and Liabilities		
(1) **Shareholders' funds**		
(a) Share capital	1	12,05,000
(b) Reserves and Surplus	2	1,95,000
(2) **Non-current liabilities**		
(a) Long-term borrowings	3	5,00,000
		19,00,000

Notes to Accounts

No		₹	₹
1	**Share Capital**		
	Authorised share capital		
	1,12,500 Equity shares of ₹10 each	11,25,000	
	10,000 12% Preference shares of ₹10 each	1,00,000	12,25,000
	Issued, subscribed and fully paid share capital		
	1,12,500 Equity shares of ₹10 each, fully paid (Out of above, 22,500 equity shares @ ₹10 each were issued by way of bonus)	11,25,000	
	8,000 12% Preference shares of ₹10 each	80,000	**12,05,000**
2	**Reserves and Surplus**		
	General Reserve	1,60,000	
	Less : Used for Bonus	(1,60,000)	Nil
	Revaluation Reserve		35,000
	Securities Premium	20,000	
	Less: Utilised for bonus	(20,000)	Nil
	Profit & Loss Account	2,05,000	

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	Less: Utilised for bonus issue	(45,000)	1,60,000
	Total		**1,95,000**
3	**Long-term borrowings**		
	Secured		
	12% Debentures @ ₹100 each		**5,00,000**

Illustration – 3

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

Solution: Illustration 3

Cum Right (Market) Price =₹150

Issue Price = 100 + 25% of 100

= 100 + 25 = ₹125

Ratio = 1:4

Theoretical Ex – Right Price = $\frac{4\times₹150+1\times₹125}{4+1}$

= $\frac{₹725}{5}$ = ₹145

Value of Right = Market Price - Theoretical Ex – Right Price

= ₹150 – ₹145 = ₹5

*This Method is Recommended for Exams

OR

Value of Right = $\frac{\text{Theoretical Ex – Right Price}-\text{Issue Price}}{\text{No.of Shares Held}}$

= $\frac{₹145-₹125}{4}$ = ₹5

OR

Value of Right = $\frac{\text{Market Price}-\text{Issue Price}}{\text{No.of Shares Held (After Rights)}}$

= $\frac{₹150-₹125}{5}$ = ₹5

Illustration 4

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

	Rs.
Authorised capital:	
30,000 12% Preference shares of Rs. 10 each	**3,00,000**
4,00,000 Equity shares of Rs. 10 each	**40,00,000**
	43,00,000
Issued and Subscribed capital:	

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24,000 12% Preference shares of Rs. 10 each fully paid	**2,40,000**
2,70,000 Equity shares of Rs. 10 each, Rs. 8 paid up	**21,60,000**
Reserves and surplus:	
General Reserve	**3,60,000**
Capital Redemption Reserve	**1,20,000**
Securities premium (collected in cash)	**75,000**
Profit and Loss Account	**6,00,000**

On 1st April, 20X1, the Company has made final call @ Rs. 2 each on 2,70,000 equity shares. The call money was received by 20th April, 20X1. Thereafter, the company decided to capitalize its reserves by way of bonus at the rate of one share for every four shares held.
Show necessary journal entries in the books of the company and prepare the relevant extract of the balance sheet as on 30th April, 20X1 after bonus issue.

Solution: Illustration 4

Journal Entries in the books of Manoj Ltd.

Particulars			**Dr. (₹)**	**Cr. (₹)**
20X1				
April 1	Equity Share Final Call A/c	Dr.	5,40,000	
	To Equity Share Capital A/c			5,40,000
	(Final call of ₹2 per share on 2,70,000 equity shares due as per Board's Resolution dated ...)			
April 20	Bank A/c	Dr.	1,80,000	
	To Equity Share Final Call A/c			1,80,000
	(Being Final Call Amount Received)			
April 20	Securities Premium A/c	Dr.	75,000	
	Capital Redemption Reserve A/c	Dr.	1,20,000	
	General Reserve A/c	Dr.	3,60,000	
	Profit and Loss A/c (b.f.)	Dr.	1,20,000	
	To Bonus to Shareholders A/c (Bonus issue @ 1 share for every 4 shares held by utilising various reserves as per Board's Resolution dated...)			6,75,000
April 20	Bonus to Shareholders A/c	Dr.	6,75,000	
	To Equity Share Capital A/c			6,75,000
	(Capitalisation of profit)			

Extract of Balance Sheet as at 30th April, 20X1 (after bonus issue)

Particulars	**Amount (₹)**
Authorized Capital	
30,000 12% Preference shares of ₹10 each	3,00,000

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4,00,000 Equity shares of ₹10 each	40,00,000
Issued and subscribed capital	
24,000 12% Preference shares of ₹10 each, fully paid	2,40,000
3,37,500 Equity shares of ₹10 each, fully paid	33,75,000
(Out of the above, 67,500 equity shares @ ₹10 each were issued by way of bonus shares)	
Reserves and surplus Profit and Loss Account	 4,80,000

Value of right share = Cum-right value of the share – Ex-right value of the share (working Note)

= ₹190 – ₹176 = ₹14 per share

Working Note:

= (Cum-right value of the existing shares + Rights shares x Issue Price) / (Existing No. of shares + No. of right shares) = (₹190 X 4 Shares + ₹120 X 1 Share) / (4 + 1) Shares

= ₹880 / 5 shares = ₹176 per share

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UNIT 4 - Buy-Back Of Securities

1. Introduction

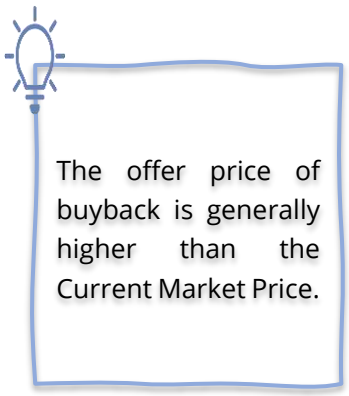
Buy back of shares mean purchase of its own share by the company from the existing shareholders. It results in decrease of share capital of the Company.
The buyback of shares is also known as **Stock Buyback** or **Repurchase of Shares**.
Sec 68 of the Companies Act, 2013 empowers a company to purchase its own shares.
There are normally two types of buyback in the stock market:

- **Open Market Route**: In this method company buys its shares directly from the market via its brokers. It is generally time taking and company repurchases its shares at current market.
- **Tender Offer**: An Investor friendly method which involves company to make tender offer to shareholders to buy back their shares at fixed date and at a fixed price (usually at a premium). The interested shareholders submit their tenders specifying whole or a portion of their holding to be bought back by the company.

Note: *The above methods are for general knowledge of the students and is not relevant for exam purpose.*

2. Objectives of Buyback

a) **To increase Earnings per share** : If there is no dilution in company's earnings, the EPS increases as the number of outstanding shares is reduced with the buyback.
b) **To Increase in Promoters holding**: Shares which are bought back are cancelled, hence the promoter holding is increased.
c) **Discourage takeover**: Since the promoter holding is increased after the buyback, it discourage others to make hostile bid to take over the company.
d) **Support Share Price**: In the case of bearish market, when the company feels that the Current market price is less than it's intrinsic value, company announces buyback to support the share price in short term.
e) **Distribute surplus cash**: Company opts for buyback when they have surplus cash and do not have alternative investment opportunity, so they give the surplus cash back to shareholders.



For Example : IT giant **Infosys** has a capital allocation policy of returning **85% of the free cash flow** (Net Operating Cash Flow less capital expenditure) to the shareholders cumulatively over 5 Year period in the form of Dividends, Share Buyback etc.

3. Buyback Tests

As per Sec 68 of the Companies Act, there are some restrictions or conditions to be fulfilled for the purpose of buyback. The three tests which needs to be complied with are :

- **Shares Outstanding Test:** Number of shares to be bought back should not exceed 25% of the Equity shares outstanding in the financial year.

Example 1: If the shares outstanding of ABC Ltd are 2 Crores, then the number of shares which can be bought back will be : 2Cr x 25% = 50Lakhs.
Hence company can bought back maximum of 50 Lakhs shares from this test.

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- **Resource Test:** Amount to be used for buy-back of shares should not exceed 25% of the Total Paid up Share Capital **AND** free reserves of the company

Example 2 : Suppose ABC Ltd has Paid up Capital of ₹500 Crores, General Reserve of ₹ 100 Crores and Securities Premium Reserve of ₹ 200 Crores.
Then the amount which can be used for the purpose of buyback is 25% of ₹800 Crores (500+100+200) = ₹200 Crores.

let's say the buyback price is Rs 200, then the Quantum of shares which can be bought back = ₹200 Crores/ ₹200 = 1Crore shares.

For the purpose of this test, Free reserves **also includes** Securities premium reserves.

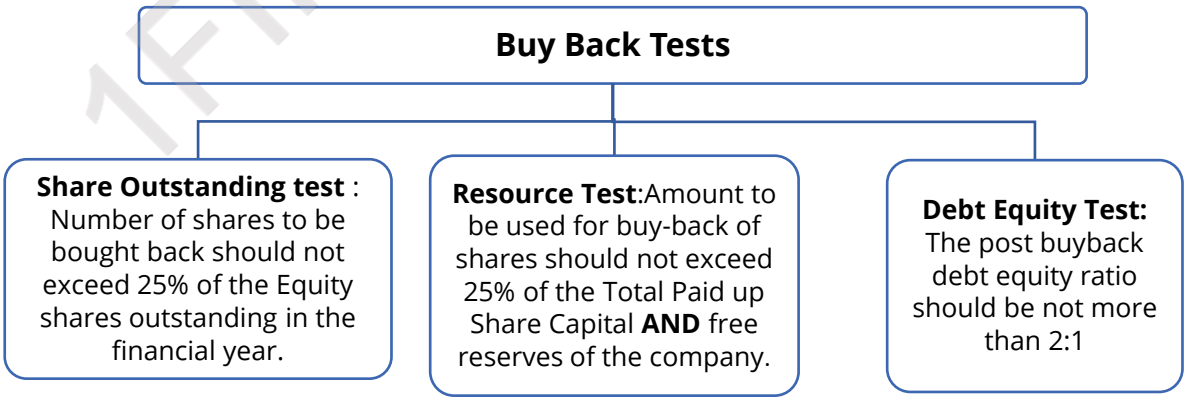
- **Debt Equity Test:** The post buyback debt equity ratio should be not more than 2:1.
In other words, the total debt (Both secured and unsecured) after buyback should not be more than twice the amount of paid up capital and its free reserves.

Example 3 : Suppose ABC Ltd has debt obligations worth ₹1500 Crores, and before buy back it has equity(shareholders fund) of ₹ 900 Crores.

Then the company can only afford buyback of ₹ 150 Crores of equity as post buy back equity will be ₹750 Crores which is half of Debt. (Debt equity ration of 2:1 to be maintained).
Considering the same buy back price of Rs 200, company can buy back shares = ₹150 Cr/ ₹200 =75 Lakhs shares.

From Examples 1,2 and 3 above, ABC ltd can buyback 50 Lakhs shares (Lower of the three), as it satisfy all the three tests.

A company needs to satisfy **All the three tests** for the purpose of buyback.



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4. Resources for Buyback

As per sec 68(1) of the Companies Act, 2013 company can buyback their shares from two sources:

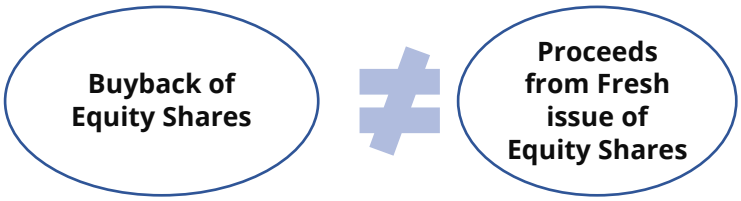
- Proceeds from the issue of fresh shares or any other securities.
- From existing resources.

4.1 Proceeds from Fresh Issue

In this method, company can source buyback by issuing any new shares or securities and use the proceeds out of it to pay to the shareholders.

However, **no buyback can be made** from the proceeds of the same kind of shares or securities which are to be bought back.

For Example: If XYZ ltd decides to buyback its equity shares, then XYZ Ltd **cannot use** proceeds from new issue of same equity shares for the purpose of buyback. Lets say if **preference shares are issued**, then the company is **eligible to buyback** equity shares from the proceeds of preference issue.



4.2 Using existing resources

Apart from fresh issue, company can use its free reserves, like General reserves, P&L and Securities premium reserves for the purpose of buyback.

As per Sec 69, where a company buys back its shares from free reserves or Securities Premium, a sum equal to the nominal value of shares shall **be transferred to the Capital Redemption Reserve** Account (CRR) and it should be disclosed in the balance sheet.

One thing to note here Is that the requirement of creation of CRR occurs **only when** the company is **using existing resources to source buyback**. When the company is using proceeds from the fresh issue, the requirement of creation of **CRR does not exists**.

The amount lying in CRR Account cannot be used for the purpose of payment of dividend and **can only be used** for the purpose of issue of **bonus shares**.

Example : Suppose Company is buying back its equity shares worth 200 Crores, out of which 50 Crores is sourced from the proceeds of fresh issue and balance 150 Crores will be utilised from General Reserve, let's say.

In this case, the amount to be transferred to CRR Account will be only 150 Crores and it is only used from existing resources.

Journal Entry to be passed :

General Reserve A/c	Dr	150 Cr
To Capital Redemption Reserve A/c		150 Cr

5. Other Provisions related to Buy-back

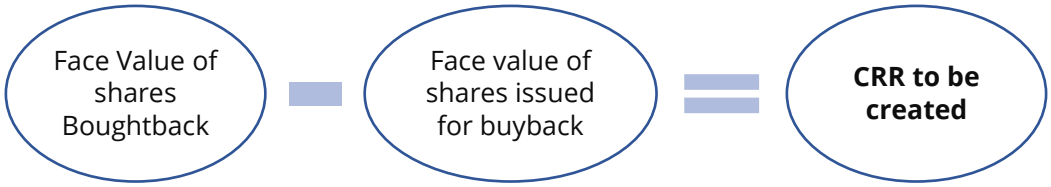
The other important provisions related to buyback are:

- The shares which are to be bought back should be **fully paid up**.
- The buyback should be **authorised by articles** of the company and should be accompanied by passing of **special resolution** in general meeting of the company.

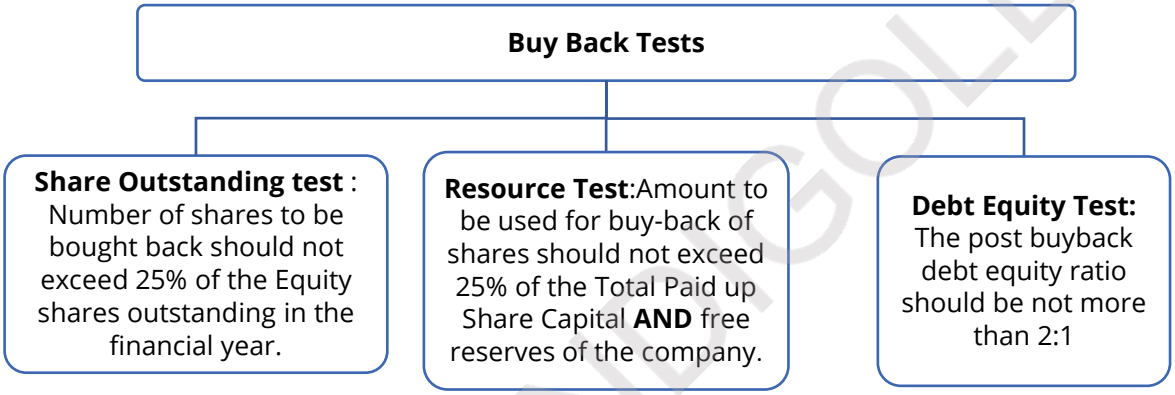
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However, if the buyback is **Upto 10% of paid up equity and free reserves**, then the authorisation of **board resolution** will suffice for the purpose of buyback.

- The buyback cannot be made within a period of one year from the date of closure of last buyback. In other words, there **cannot be more than one buyback in any given year**.
- Buyback shall be completed **within one year** from the passing of special resolution.
- The securities which are bought back should be **physically destroyed within seven days** from the last date of completion.



6. Summary



7. Illustrations

1. Illustration

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

Liabilities	Rs. in ('000)	Rs. in ('000)
Equity and liabilities		
Share capital:		
Authorized capital:		5,000
Issued and subscribed capital		
3,00,000 equity shares of Rs.10 each fully paid up	3,000	
20,000 9% preference shares of Rs.100 each	2,000	
(issued two months back for the purpose of buy back)		5,000
Reserves and surplus:		
Capital reserves	10	
Revenue reserves	4,000	
Securities premium	500	
Profit and loss account	1,800	6310
Non- current liabilities – 10% debentures		400
Current liabilities and provisions		40

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Total		**11,750**
Assets	**Rs. in ('000)**	**Rs. in ('000)**
Fixed Assets Cost	3,000	
Less: Provision for depreciation	250	2,750
Non-current investments at cost		5,000
Current assets, loans and advances (including cash and bank balances)		4,000
Total		**11,750**

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

Solution 1

Journal entries in the books of M ltd

Date	Particulars	Dr ₹ ('000)	Cr ₹ ('000)
31st March 2011	Bank A/c Dr	25,00	
	Profit and Loss A/c Dr	5,00	
	To Investment A/c		30,00
	(Being investment sold at a loss)		
	Equity share capital A/c (60,000 x ₹10) Dr	6,00	
	Premium on buy-back A/c Dr	3,00	
	To Bank A/c **[Note : 1]**		9,00
	(Being buy-back of 60,000 shares at ₹50 each)		
	OR		
	Equity share capital A/c (60,000 x ₹10) Dr	6,00	
	Premium on buyback A/c Dr	3,00	
	To Equity share buy-back A/c		9,00
	(Being amount due on buy-back of equity shares)		
	Equity share buy-back A/c Dr	9,00	
	To Bank A/c		9,00
	(Being Payment made for buy-back of equity shares)		
	Securities Premium A/c Dr	3,00	
	To premium on buy-back A/c		3,00
	(Being premium on buy-back written off against securities premium)		

Note: 1 No. of shares bought back

1	Total No. of shares	3,00,000
2	5 of buy-back	20%
3	No. of bought back (1 x 2)	60,000
4	Buy-back price	₹15 per share

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5	**Total amount paid (3 x 4)**	**9,00,000**

Note: 2

1	Face value of shares bought back	600
2	Face value of shares issued for buy-back	2,000
3	Shortfall	0
4	**Capital Redemption Reserve**	**No**

2. Illustration

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

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

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

You are asked to:

(i) pass journal entries to record the above.

(ii) prepare balance sheet as at 1.04.2011 [Source ICAI]

Solution 2

(i) **Journal entries in the books of Anu Ltd**

Date	**Particulars**		**Dr ₹ (Crores)**	**Cr ₹ (Crores)**
31st March 2011	12% Preference share capital A/c	Dr	75	
	To preference shareholders A/c			75

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	(Being Preference shares due for redemption)		
"	Preference shareholders A/c Dr To Bank A/c (Being preference shareholders paid)	75	 75
"	Revenue reserve A/c Dr To Capital Redemption Reserve A/c (Being CRR created for Preference share redeemed) [Note:1]	75	 75
31st March 2011	Equity share capital A/c (50 lakhs x ₹10) Dr Premium on buy-back A/c (50 lakhs x ₹40) Dr To share buy-back A/c (50 lakhs x ₹50) (Being Equity shares due for buy-back)	5 20	 25
"	Share buy-back A/c Dr To Bank A/c (Being amount paid for equity share bought back)	25	 25
"	Securities premium A/c Dr To Premium on buy-back A/c (Being premium on shares bought back written off against securities premium)	20	 20
"	Revenue reserve A/c Dr To Capital Redemption Reserve A/c (Being CRR created for Equity shares bought back by debiting revenue reserve) [Note :2]	5	 5

(ii) Balance sheet of Anu Ltd as at 1.4.2011

		Particulars	Notes	₹ (in crores)
		Equity and Liabilities		
1		**Shareholder's funds**		
	A	Share capital	1	20
	B	Reserves and Surplus	2	280
2		**Current liabilities**		
	A	Trade Payables		40
		Total		**340**
		Assets		
		Non-current assets		
1	A	Property, plant and equipment	3	-
	B	Non-Current Investments	4	100
		Current assets		
2	A	Trade receivables		140
	B	Cash and Cash equivalents	5	100
		Total		**340**

Notes to accounts

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S.no	Particulars		₹ (in crores)
1	**Share Capital**		
	Authorised, issued and subscribed share capital: 200 lakhs Equity shares of ₹10 each fully paid		20
	Total		20
2	**Reserves and Surplus**		
	Capital reserves		15
	Capital redemption reserve		80
	Securities premium	25	
	Less: Utilisation for buy-back of shares	(20)	5
	Revenue Reserve	260	
	Less: transfer to Capital redemption reserve	(80)	180
	Total		280
3	**Property, Plant and Equipment**		100
	PPE: cost		(100)
	Less: Provision for depreciation		
	Net carrying value		-
4	**Non-Current Investments**		
	Non-Current Investments at cost (Market value ₹400 Crores)		100
5	**Cash and Cash Equivalents**		
	Cash and Cash Equivalents as on 31.3.2011		200
	Less: Bank payment for redemption and buy-back		(100)
	Total		100

Note: 1

		₹ (crores)
1	Face value of preference shares redeemed	75
2	Face value of shares issued for buy-back	0
3	**Capital Redemption Reserve to be created (1-2)**	**75**

Note: 2

		₹(crores)
1	Face value of shares bought back	5
2	Face value of shares issued for buy-back	0
3	**Capital Redemption Reserve to be created**	**5**

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3. Illustration

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

Liabilities	Rs. ('000)	Rs. ('000)
Share capital: Authorised capital		30,00
Issued and subscribed capital: 2,50,000 equity shares of Rs.10 each fully paid up 2,000, 10% preference shares of Rs.100 each	25,00 2,00	
(issued two months back for the purpose of buy back)		
Reserves and surplus: Capital reserves	10,00	
Revenue reserves	30,00	
Securities premium Profit and loss account	22,00 35,00	97,00
Current liabilities and provision		14,00
Total		**1,38,00**
Assets		
Fixed assets		93,00
Investments		30,00
Current assets, loans and advances (including cash and bank balances)		15,00
Total		**1,38,00**

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

Solution 3

Journal entries in the books of M ltd

Date	Particulars		Dr ₹ ('000)	Cr ₹ ('000)
31st March 2011	Bank A/c	Dr	22,00	
	Profit and Loss A/c	Dr	8,00	
	To Investment A/c			30,00
	(Being investment sold at a loss)			
"	Equity share capital A/c	Dr	5,00	
	Premium on buyback A/c	Dr	20,00	
	To Equity share buy-back A/c			25,00
	(Being amount due on buy-back of equity shares)			
"	Equity share buy-back A/c	Dr	25,00	
	To Bank A/c			25,00
	(Being Payment made for buy-back of equity shares)			
"	Securities Premium A/c	Dr	20,00	
	To premium on buy-back A/c			20,00
	(Being premium on buy-back written off against securities premium)			
"	Revenue reserve A/c	Dr	3,00	

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	To Capital Redemption Reserve A/c (Being CRR created for Equity shares bought back by debiting revenue reserve)		3,00

Balance Sheet of Dee Limited as at 1st April, 2011
(After buy-back of shares)

		Particulars	Notes	₹ ('000)
		Equity and Liabilities		
1		**Shareholder's funds**		
	A	Share capital	1	22,00
		Reserves & Surplus	2	69,00
2		**Non-Current liabilities**		
	A	Long-term borrowings		
3		**Current liabilities & Provision**		14,00
		Total		**1,05,00**
		Assets		
	A	**Non-current assets**		
1		Property, plant and equipment		93,00
		Investments		
2		**Current assets**		12,00
		Total		**1,05,00**

Notes to accounts

S.no	Particulars		₹ ('000)
1	**Share Capital**		
	Authorised, issued and subscribed share capital:		
	2,50,000 Equity shares of ₹10 each fully paid		20,00
	2,000, 19% Preference shares of ₹100 each (issued two months back for the purpose of buy-back)		2,00
2	**Total**		**22,00**
	Reserves and Surplus		
	Capital reserves		10,00
	Capital redemption reserve		3,00
	Securities premium	22,00	
	Less: Utilisation for buy-back of shares	(20,00)	2,00
	Revenue Reserve	30,00	
	Less: transfer to Capital redemption reserve	(3,00)	27,00
	Profit and loss A/c	35,00	
	Less: Loss on investment	(8,00)	27,00
	Total		**69,00**

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4. Illustration

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

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

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

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

You are required to compute the maximum number of shares that can be brought back in the light of the above information and also under a situation where the loan funds ofthe company were Rs.1, 200 crores or Rs. 1,500 crores. Assuming that the buyback is completed by 09.12.2011, show the accounting entries in the company's books in each situation.

Solution 4

Journal entries in the books of Perrotte Ltd

Date	Particulars	Dr ₹ ('000)	Cr ₹ ('000)
31st March 2011	Equity share capital A/c Dr Premium on buyback A/c Dr To Equity share buy-back A/c (Being amount due on buy-back of 3.75 crores equity shares of ₹10 each @ ₹30 per share)	37.5 75	 112.5
"	Equity share buy-back A/c Dr To Bank A/c (Being Payment made for buy-back of equity shares	112.5	 112.5
"	Securities premium A/c Dr To Premium on buy-back A/c (Being premium on shares bought back written off against securities premium)	75	 75
"	General reserve A/c Dr To Capital Redemption Reserve A/c	37.5	 37.5

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	(Being CRR created for Equity shares bought back by debiting General reserve)		

Working Notes:

1. Shares Outstanding Test

	Particulars	
A	Paid up share capital	₹ 330 Crores
B	Face value per share	₹ 10
C	No. of shares(A/B)	33 Crores Shares
D	25% of Shares outstanding	8.25 Crore Shares

2. Resource Test

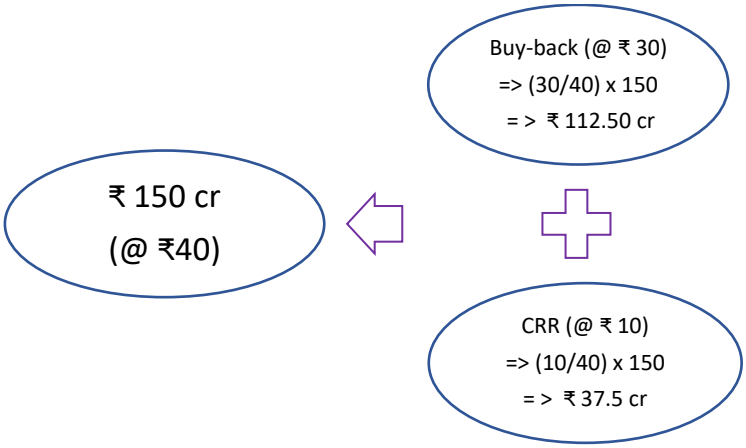
	Particulars	₹
A	Eq share capital (Paid up)	330 Crores
B	Preference share capital (Paid up)	0
C	Free Reserves : General Reserves - 240cr Profit and loss A/c - 90cr Securities Premium - 90cr	420 Crores
D	Shareholders funds (A+B+C)	750 Crores
E	Max. Resources that we can use for buy-back ⇨ 25% of (D)	187.5 Crores
F	Buy-back price (₹25 + 20%)	30
G	Max. No. of Shares can bought back ⇨ (E/F) = 187.5 / 30	6.25 Crore shares

3. Post Buy-back Debt Equity Ratio Test

	Particulars	When Loan fund is		
		₹ 1,800 Crores	**₹ 1,200 Crores**	**₹ 1,500 Crores**
A	Minimum Eq Shares (Post Buy-back)	900 Cr.	600 Cr.	750 Cr.
B	Equity Before Buy-back (Refer Working Note : 2)	750 Cr.	750 Cr.	750 Cr.
C	Is Buy-back possible?	No [on account of inadequate equity]	Yes	No [on account of inadequate equity]

⇨ Reduction permissible from shareholders funds on account of buy back = ₹150 cr (including CRR)

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⇨ Max. No. of shares can be bought-back = 112.5/30 =**3.75 Crores**

Summary

	Particulars	When Loan fund is		
		₹ 1,800 Crores	₹ 1,200 Crores	₹ 1,500 Crores
A	Shares Outstanding Test	8.25 cr	8.25 cr	8.25 cr
B	Resource Test	6.25 cr	6.25 cr	6.25 cr
C	Post Buy-back Debt Equity Test	0	3.75 cr	0
D	Maximum No. of shares that can be bought back (Least of A,B,C)	0	3.75 cr	0

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UNIT 5 - ACCOUNTING FOR EMPLOYEE STOCK OPTION PLANS

1. Introduction

Employee Stock Option is a plan that gives the employees (directors, officers, or permanent employees)

- of the company or
- of its subsidiary, in India or outside India,
- or of a holding or associate of the company

• the option to purchase or subscribe to the shares of the company,
• at a fixed determinable price (usually at a concessional rate)
• for a specified periodS

Under Companies Act, 2013 special resolution is required to offer shares under ESOPs.

Employees might get dissatisfied with salary alone. ESOP ensures employee satisfaction and helps to retain talent in the organization.

Steps in the process of ESOPs



Companies Act, 2013 and SEBI (Share Based Employee Benefits) Regulations, 2014 (applicable for listed companies) cover the provisions regarding ESOPs.

2. Important terms

Share Option: a contract that gives the holder the **right**, but not the obligation, **to subscribe** to the enterprise's shares at a fixed or determinable price for a specified period of time.

Grant: the **issue of option to exercise** shares (or share option) under Employee Stock Option Plan to employees.

Grant Date: the **date** on which options are **granted**.

Vesting Period: the time an **employee must work for an employer** to own outright employee stock options, or the period during which vesting takes place

Exercise Period: the **time** period **after vesting** within which an employee should **exercise** his right to apply for the shares vested in him under the ESOP.

Under the Companies Act 2013, there shall be a **minimum period of one year between the grant of options and the vesting of options**, hence the exercise period cannot be less than one year from the date of the grant of the options

Exercise: making of an **application by an employee** to the company for the **issue of shares** against the option vested in him under the ESOP.

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Exercise Price: price **payable** for the share on exercising the option, which is usually **concessional**.

3. Importance of ESOP:

- Provides an opportunity for employees **to participate and contribute to the growth** of the company.
- **Creates long-term wealth** in the hands of the employees.
- Helps to **attract, retain and motivate the best available talent** for the company.
- It creates a common **sense of ownership** between the company and its employees.

Unlisted companies, especially start-ups, use ESOPs as they cannot afford high pay to talented staff.

4. Methods of Accounting

- **Intrinsic Value Method:** intrinsic value is the **excess** of the **market price** of the share under ESOP **over the exercise price** of the option.

- **Fair Value Method:** This method is recommended by the Guidance Note, however, the intrinsic value method is also permitted.

Fair value is the **amount** for which a **share** could be **exchanged**, between knowledgeable, willing parties in an arm's length transaction

5. Journal entries

Date	Particulars	Debit (₹)	Credit(₹)
1	**To recognize a proportionate expense at the end of each accounting period during the vesting period.** Employees Compensation Expenses A/c Dr. To Employees stock option outstanding A/c (Being expenses in respect of ESOP recognized during the year)		
2	**To transfer employees compensation expense account to profit & loss Account at the end of each accounting period during the vesting period.** Profit & Loss A/c Dr. To Employees Compensation Expenses A/c (Being the transfer of employees compensation expense A/c to P & LA/c).		

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3	**When the options are exercised.** Bank Account Dr. Employees Stock Option Outstanding Account Dr. To Equity Share Capital A/c To Securities Premium A/c (Being X options exercised)		
4	**To cancel the fair value of the options lapsed.** Employees Stock Option Outstanding A/c Dr. To General Reserve (Being the fair value of lapsed options transferred to general reserve)		

6. Illustrations

1. Illustration

A Company has its share capital divided into shares of Rs.10 each. On 1st April, 20X1 it granted 10,000 employees' stock options at Rs 40, when the market price was Rs.130. The options were to be exercised between 15th March, 20X2 and 31st March, 20X2. The employees exercised their options for 9,500 shares only; the remaining options lapsed. The company closes its books on 31st March every year.
Show Journal Entries

Solution 1

Journal entries

Date	Particulars	Dr ₹	Cr ₹
15th March 20X2 to 31st March 20X2	Bank A/c (9,500 x 40) Dr Employee compensation expenses A/c [9,500 x (130-40)] Dr To Equity share capital A/c (9500 x 10) To Securities premium A/c [9,500 x (130-10)] (Being allotment of shares for 9500 options, ₹ 40 exercise price, ₹ 130 issue price)	3,80,000 8,55,000	 95,000 11,40,000
31st March 20X2	Profit and Loss A/c Dr To Employee compensation expenses A/c (Being expenses charged off to Profit and Loss A/c)	8,55,000	8,55,000

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2. Illustration

ABC Ltd. grants 1,000 employees stock options on 1.4.20X0 at Rs 40, when the market price is Rs. 160. The vesting period is 21⁄2 years and the maximum exercise period is one year .300 unvested options lapse on 1.5.20X2. 600 options are exercised on 30.6.20X3. 100 vested options lapses at the end of the exercise period.

Show Journal Entries.

Solution 2

Journal entries

Date	Particulars	Dr ₹	Cr ₹
31st March 20X1	Employee compensation expenses A/c Dr To Employee stock option outstanding A/c (Being expenses for year 1 recognized) [Note:1]	48,000	48,000
31st March 20X1	Profit and Loss A/c Dr To Employee compensation expenses A/c (Being year 1 expenses charged off to Profit and Loss A/c)	48,000	48,000
31st March 20X2	Employee compensation expenses A/c Dr To Employee stock option outstanding A/c (Being expenses for year 2 recognized) [Note:2]	48,000	48,000
31st March 20X2	Profit and Loss A/c Dr To Employee compensation expenses A/c (Being year 2 expenses charged off to Profit and Loss A/c)	48,000	48,000
31st March 20X2	Employee stock option outstanding A/c Dr To General reserves A/c (Being Employee stock option outstanding A/c reduced) [Note:3]	12,000	12,000
31st March 20X3	Bank A/c (40 x 600) Dr Employee stock option outstanding A/c (120 X 600)Dr To Equity share capital A/c (10 X 600) To Securities premium A/c (150 X 600) (Being allotment of share for 600 options vested & exercised)	24,000 72,000	 6,000 90,000

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31st March 20X3	Employee stock option outstanding A/c Dr To General reserves A/c (Being vested option lapsed transferred to General reserves)	12,000	12,000

Note: 1 [31/3/20X1]

No. of options	1,000
Cost per option (160-40)	120
Total cost for 2.5 years (1000 x 120)	1,20,000
Cost for 1st year	=1,20,000x1/2.5 **=48,000**

Note: 2 [31/3/20X2]

No. of options	1,000
Cost per option (160-40)	120
Total cost for 2.5 years (1000 x 120)	1,20,000
Cost upto 31/3/20X2	=1,20,000x 2/2.5 =96,000
Less: Expenses charged off upto end of previous period	=(48,000)
Current period cost	**48,000**

Note: 3 [30/09/20X3] or [31/3/20X3]

No. of options	700
Cost per option (160-40)	120
Total cost for 2.5 years (1000 x 120)	84,000
Cost already incurred	96,000
=> Extra cost of ₹ 12,000 should be reduced from Employee stock option outstanding A/c.	

3. Illustration

Arihant Limited has its share capital divided into equity shares of Rs.10 each. On 1- 10-20X1, it granted 20,000 employees' stock options at Rs.50 per share, when the market price was Rs. 120 per share. The options were to be exercised between 10th December, 20X1 and 31st March, 20X2. The employees exercised their options for 16,000 shares only and the remaining options lapsed. The company closes its books on 31st March every year. Show Journal Entries (with narration) as would appear in the books of the company upto 31st March, 20X2.

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Solution 3

Journal entries

Date	Particulars	Dr ₹	Cr ₹
15th December 20X1 to 31st March 20X2	Bank A/c (16,000 x 50) Dr Employee compensation expenses A/c [16,000 x (120-50)] Dr To Equity share capital A/c (16,000 x 10) To Securities premium A/c [16,000 x (120-10)] (Being allotment of shares for 16,000 options, ₹ 50 exercise price, ₹ 120 issue price)	8,00,000 11,20,000	 1,60,000 17,60,000
31st March 20X2	Profit and Loss A/c Dr To Employee compensation expenses A/c (Being expenses charged off to Profit and Loss A/c)	11,20,000	11,20,000

4. Illustration

Ajanta grants 120 share options to each of its 460 employees. Each grant is conditional on the employee working for Ajanta over the next three years. Ajanta has estimated that the fair value of each share option is Rs.12. Ajanta estimates that 25% of employees will leave during the three-year period and so forfeit their rights to the share options. Everything turns out exactly as expected.

Required:

Calculate the amounts to be recognized as expense during the vesting period

Solution 4

Year	Calculations	Expenses for period ₹	Cumulative Expenses ₹
1	55,200 options x 75% x ₹12 x 1/3 years	1,65,600	1,65,600
2	(55,200 options x 75% x ₹12 x 2/3 years) - ₹ 1,65,600	1,65,600	3,31,200
3	(55,200 options x 75% x ₹12 x 3/3 years) - ₹ 3,31,200	1,65,600	4,96,800

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5. Illustration

Choice Ltd. grants 100 stock options to each of its 1,000 employees on 1.4.20X1 for Rs.20, depending upon the employees at the time of vesting of options. Options would be exercisable within a year it is vested. The market price of the share is Rs.50 each.

These options will vest at the end of year 1 if the earning of Choice Ltd. is 16%, or it will vest at the end of the year 2 if the average earning of two years is 13%, or lastly it will vest at the end of the third year if the average earning of 3 years will be 10%. 5,000 unvested options lapsed on 31.3.20X2. 4,000 unvested options lapsed on 31.3.20X3 and finally 3,500 unvested options lapsed on 31.3.20X4.

Following is the earning of Choice Ltd:

Year Ended on	Earning (in %)
31.3.20X2	14%
31.3.20X3	10%
31.3.20X4	7%

850 employees exercised their vested options within a year and remaining options were unexercised at the end of the contractual life. Pass Journal entries for the above.

Solution 5

Journal entries

Date	Particulars	Dr ₹	Cr ₹
31st March 20X2	Employee compensation expenses A/c Dr To Employee stock option outstanding A/c (Being expenses for year 1 recognized and amortised over vesting period) [Note:1]	14,25,000	14,25,000
31st March 20X2	Profit and Loss A/c Dr To Employee compensation expenses A/c (Being year 1 expenses charged off to P&L A/c)	14,25,000	14,25,000
31st March 20X3	Employee compensation expenses A/c Dr To Employee stock option outstanding A/c (Being expenses for year 2 recognized and amortised over vesting period) [Note:2]	3,95,000	3,95,000
31st March 20X3	Profit and Loss A/c Dr To Employee compensation expenses A/c (Being year 2 expenses charged off to Profit & Loss A/c)	3,95,000	3,95,000
31st March 20X3	Employee compensation expenses A/c Dr To Employee stock option outstanding A/c (Being expenses for year 3 recognized and amortised over vesting period) [Note:3]	8,05,000	8,05,000

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31st March 20X3	Profit and Loss A/c Dr To Employee compensation expenses A/c (Being year 3 expenses charged off to Profit & Loss A/c)	8,05,000	8,05,000
31st March 20X4	Bank A/c (85,000x20) Dr Employee stock option outstanding A/c (85,000x30) Dr To Equity share capital A/c (85,000 X 10) To Securities premium A/c (85,000X40) (Being allotment of share for 85,000 options vested & exercised) [Note:4]	17,00,000 25,50,000	 8,50,000 34,00,000
31st March 2022	Employee stock option outstanding A/c Dr To General reserves A/c (Being ESOP outstanding A/c on lapse of 2,500 options at the end of exercise of option period transferred to capital reserves A/c)	75,000	75,000

Note: 1 [31/3/20X2]

1	Total No. of employees as on 1/4/20X2	1,000
2	Options per employee	100
3	Total no. of options (1x2)	1,00,000
4	No. of unvested options lapsed	5,000
5	Best estimate of options that would be vested (3-5)	95,000
6	Cost per option (50-30)	30
7	Total cost (5x6)	28,50,000
8	Vesting period : As earnings % of 1st year is 14%, which is not ≥16%. Options cannot be vested on 31/3/20X2) ⇨ It is assumed that they would be vested on 31/3/20X3 (i.e. 2 years of vesting)	
9	Total cost should be divided over 2 years ⇨ Cost for 31/3/20X2	=28,50,000 x ½ = 14,25,000

Note: 2 [31/3/20X3]

1	No. of options as on 31/3/20X2	95,000
2	Less: Unvested option lapsed as on 31/3/20X3	4,000
3	No. of options expected to be vested (1-2)	91,000
4	Cost per option	30
5	Total cost (3x4)	27,30,000
6	Actual earning over 2 years [refer Note : 1]	12%
7	AS (6) is not ≥13% options will not be vested as on 313/20X3	-
8		-

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	⇨ It is assumed that they would be vested on 31/3/20X4 (i.e. 3 years of vesting)	
9	Cost to be charged off in 31/3/20X3	=[(27,30,000x2/3)-14,25,000] =3,95,000

Note: 3 [31/3/20X4]

1	No. of options as on 31/3/20X3	91,000
2	Less: Unvested option lapsed as on 31/3/20X4	3,500
3	No. of options expected to be vested (1-2)	87,500
4	Cost per option	30
5	Total cost (3x4)	=26,25,000
6	Actual average earning over 3 years	10.33%
7	AS (6) is >10% options will be vested as on 313/20X4 => Total cost should be charged off to over 3 years as nesting condition is met .	-
8	Cost to be charged off in 31/3/20X3	=26,25,000-14,25,000-3,95,000 =8,05,000

Note: 4 Exercise period

1	No. of options Vested	87,500
2	No. of options exercised (850 employees x 100)	85,000
3	Vested options which lapsed (1-2)	2,500

6. Illustration

P Ltd. granted option for 8,000 equity shares of nominal value of Rs.10 on 1st October, 20X0 at Rs. 80 when the market price was Rs. 170.The vesting period is 4 1⁄2 years, 4,000 unvested options lapsed on 1st December, 20X2, 3,000 options were exercised on 30th September, 20X5 and 1,000 vested options lapsed at the end of the exercise period. Pass Journal Entries for above transactions

Solution 6

Journal entries

Date	Particulars	Dr ₹	Cr ₹
31st March 20X1	Employee compensation expenses A/c Dr To Employee stock option outstanding A/c (Being expenses for year 1 recognized and amortised over vesting period) [Note:1]	80,000	80,000
31st March 20X1	Profit and Loss A/c Dr To Employee compensation expenses A/c (Being year 1 expenses charged off to P&L A/c)	80,000	80,000

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31st March 20X2	Employee compensation expenses A/c Dr To Employee stock option outstanding A/c (Being expenses for year 2 recognized and amortised over vesting period) [Note:2]	1,60,000	1,60,000
31st March 20X2	Profit and Loss A/c Dr To Employee compensation expenses A/c (Being year 2 expenses charged off to Profit and Loss A/c)	1,60,000	1,60,000
31st March 20X3	Employee stock option outstanding A/c Dr To General reserves A/c (Being Accumulated cost outstanding on unvested % lapsed options- 4,000,transferred to General reserves A/c) [Refer guidance note]	1,20,000	1,20,000
31st March 20X3	Employee compensation expenses A/c Dr To Employee stock option outstanding A/c (Being expenses for year 3 recognized and amortised over vesting period) [Note:3]	80,000	80,000
31st March 20X3	Profit and Loss A/c Dr To Employee compensation expenses A/c (Being year 3 expenses charged off to Profit and Loss A/c)	80,000	80,000
31st March 20X4	Employee compensation expenses A/c Dr To Employee stock option outstanding A/c (Being expenses for year 4 recognized and amortised over vesting period) [Note:4]	80,000	80,000
31st March 20X4	Profit and Loss A/c Dr To Employee compensation expenses A/c (Being year 4 expenses charged off to Profit and Loss A/c)	80,000	80,000
31st March 20X5	Employee compensation expenses A/c Dr To Employee stock option outstanding A/c (Being expenses for year 3 recognized and amortised over vesting period) [Note:5]	80,000	80,000
31st March 20X5	Profit and Loss A/c Dr To Employee compensation expenses A/c (Being year 4 expenses charged off to Profit and Loss A/c)	80,000	80,000
31st September 20X5	Bank A/c (3,000x80) Dr Employee stock option outstanding A/c (3,000x90) Dr To Equity share capital A/c (3,000x10) To Securities premium A/c (3,000x160) (Being allotment of share for 3,000 options vested & exercised)	2,40,000 2,70,000	 30,000 4,80,000

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31st September 20X5	Employee stock option outstanding A/c Dr To General reserves A/c (Being no liability is required to be transferred) [Note:6]	90,000	90,000

Note: 1 (8,000 options x ₹ 90)/4.5 years] x 0.5 = ₹ 80,000
Note: 2 (8,000 options x ₹ 90)/4.5 years] x 1 = ₹ 1,60,000
Note: 3 (4,000 options x ₹ 90)/4.5 years] x 1 = ₹ 80,000
Note: 4 (4,000 options x ₹ 90)/4.5 years] x 1 = ₹ 80,000
Note: 5 (4,000 options x ₹ 90)/4.5 years] x 1 = ₹ 80,000
Note: 6 1,000 options x ₹ 90

Guidance Note:
Liability created but no longer required related to lapsed options has to be credited general reserves

Alternatively,

Journal entries to be passed at the year ended 31/3/20X3

31st September 20X5	Employee stock option outstanding A/c Dr To General reserves A/c (Being excess liability ,after considering the Year 3 liability to be transferred to P&L , Transferred to General reserves)	40,000	40,000

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UNIT 6 - REDEMPTION OF DEBENTURES

1. Introduction

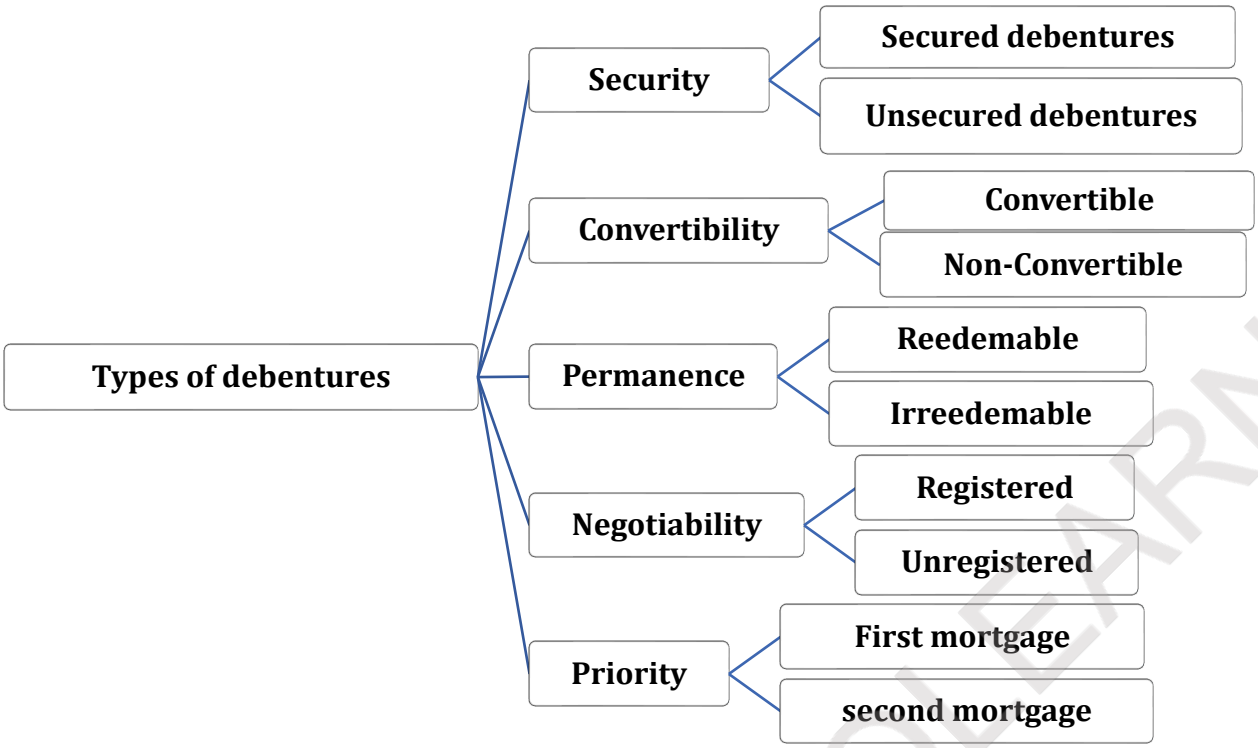
- A debenture is an instrument issued by a company under its seal, acknowledging a debt and containing provisions as regards repayment of the principal and interest
- It's a long-term debt for the company. They are commonly secured by charge. Thus, they appear under "Secured Liabilities".
- If a charge has been created on any or the entire asset of the company, the nature of the charge and the asset charged therein are described in the bond. The certificate registering the charge with the registrar is also printed on the bond.
- A trusteeship in favor of one or more persons in the case of mortgage debentures is created. The trustees of debenture holders can take any action necessary to safeguard the interest of debenture holders.
- It earns a fixed income in form of interest. Interest is payable by the company whether it earns profit or not.
- The procedure for issue of debentures is similar to that of issue of shares. Thus, the amount can be collected in lumpsum along with application or in instalments.
- In case of oversubscription, the excess applications must be rejected, and the amount should be refunded. The excess money cannot be adjusted as in case of shares.
- They can be issued for
    - Cash
    - Consideration other than cash.
    - As collateral security.
- They can be issued at
    - Par
    - Premium
    - At discount
- The terms of redemption should also be accounted at the time of issue. Redemption of debentures at a premium is a known loss at the time of issue of debentures as the terms of issue generally contain such provisions for redemption.

2. Provision Of Companies Act 2013

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

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3. Types Of Debentures



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

These are redeemable-

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

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

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

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

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

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

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

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

Registered Debentures – Those which are registered with the Registrar

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

4. Debenture Redemption Reserve – Sec 71 Of Companies Act 2013

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

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

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

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

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

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

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

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

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

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

5. Investment Of Debenture Redemption Reserve (Drr) Amount

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

- Every company required to create DRR should before the 30th day of April of each year, deposit or invest, as the case may be, a sum which should not be less than 15% of the amount of its debentures maturing during the year ending on the 31st day of March next following in any one or more of the following methods, namely:

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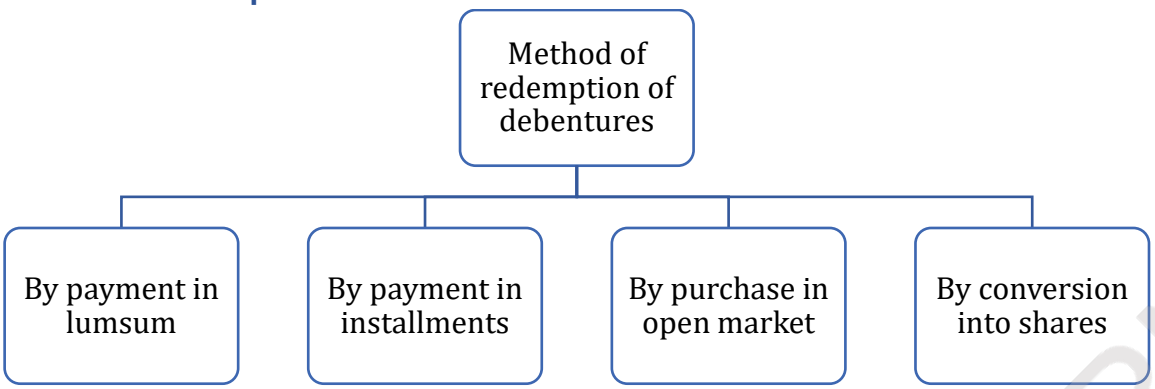
- in deposits with any scheduled bank, free from charge or lien;
- in unencumbered securities of the Central Government or of any State Government;
- in unencumbered securities mentioned in clauses (a) to (d) and (ee) of Section 20 of the Indian Trusts Act, 1882;
- in unencumbered bonds issued by any other company which is notified under clause (f) of Section 20 of the Indian Trusts Act, 1882;

- The amount deposited or invested, as the case may be, above should not be utilized for any purpose other than for the repayment of debentures maturing during the year referred to above, provided that the amount remaining deposited or invested, as the case may be, should not at any time fall below 15% of the amount of debentures maturing during the 31st day of March of that year.
- Ministry of Corporate Affairs has made the following clarification on adequacy of Debenture Redemption Reserve (DRR):

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

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6. Methods Of Redemption



By payment in lumpsum

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

By payment in Instalments

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

ACCOUNTING FOR DEBENTURE REDEMPTION FUND AND INVESTMENT

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

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Profit and Loss A/c Dr. To Debenture Redemption Reserve A/c (Being transfer of profits to Debenture redemption reserve A/c)
For investments of the amount set aside for redemption and the interest earned on DRRI Debenture Redemption Reserve Investment A/c Dr. To Bank A/c (Being amount invested in DRR investment A/c)
3. At the end of last year
For receipt of interest Bank A/c Dr. To Interest on Debenture Redemption Reserve Investment A/c (Being interest on investment received)
For transfer of interest on Debenture Redemption Reserve Investment to Profit and loss account. Interest on Debenture Redemption Reserve Investment A/c Dr. To Profit and loss A/c
For setting aside the fixed amount of profit for redemption Profit and Loss A/c Dr. To Debenture Redemption Reserve A/c
For encashment of Debenture Redemption Reserve Investments Bank A/c Dr. To Debenture Redemption Reserve Investment, A/c
For the transfer of profit/loss on realization of Debenture Redemption Reserve Investments **(i)** In case of Profit Debenture Redemption Reserve Investment A/c Dr. To profit and loss A/c Or
(ii) In case of Loss Profit and loss A/c Dr To Debenture Redemption Reserve Investment, A/c
For amount due to debenture holders on redemption Debenture A/c Dr To Debenture holder's A/c
For payment to debenture holders Debenture holder's A/c Dr To Bank A/c
For transfer of balance in DRR to General Reserve Debenture Redemption Reserve A/c Dr.

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To General reserve A/c

ACCOUNTING FOR PURCHASE OF DEBENTURES IN THE OPEN MARKET

A company, if authorized by its Articles of Association, can buy its own debentures in the open market.

This can be categorized as follows:

For immediate cancellation

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

For investment in the form of own debentures

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

Accounting treatment for purchase of own debentures for immediate cancellation.

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

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Capital Reserve A/c To Loss on redemption A/c	Dr.

ACCOUNTING FOR REDEMPTION BY CONVERSION

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

Illustrations

Illustration – 1

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

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

Solution: Illustration 1

Date	Particulars		Dr. (₹)	Cr. (₹)
30-6-x1	Bank A/c To Debenture Application A/c	Dr.	55,00,000	 55,00,000
30-6-20x1	Debenture Application A/c To 9% Debenture A/c To Securities Premium A/c (Being Allotment of Debentures)	Dr.	55,00,000	 50,00,000 5,00,000
31-3-x2	Profit & Loss A/c To Debenture Redemption Reserve A/c	Dr.	5,00,000	 5,00,000

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	(Being Creation of DRR as per the statute)			
31-3-x2	Interest on Debenture A/c To Bank A/c (1,00,000 × 50% × 9% × 9/12) (Being Interest on Debentures paid)	Dr.	3,37,500	3,37,500
31-3-x2	Profit & Loss A/c To Interest on Debenture A/c	Dr.	3,37,500	3,37,500
1-4-x2	DRR Investment A/c To Bank (Being Creation of DRR Investment)	Dr.	7,50,000	7,50,000
31-3-x3	Bank A/c To DRR Investment A/c To Interest on DRR investment A/c (Being Redemption of DRR investment)	Dr.	8,25,000	7,50,000 75,000
31-3-x3	Interest on DRR Investment A/c To Profit & Loss A/c (Interest Received on DRR Investment Transferred to P&L)	Dr.	75,000	75,000
31-3-x3	9% Debentures A/c To Debenture Holder A/c	Dr.	50,00,000	50,00,000
31-3-x3	Debenture Holder A/c To Bank	Dr.	50,00,000	50,00,000
31-3-x3	DRR A/c To General Reserve (Being Balance on DRR transferred to General Reserve)	Dr.	5,00,000	5,00,000

Illustration – 2

On January 1, Rama Ltd., had 500 Debentures of Rs.100 each outstanding in its books carrying interest at 6% per annum. DRR balance is standing in books at

12,500/-. In accordance with the powers in the deed, the directors acquired debentures from the open market for immediate cancellation as follows:

March 1 Rs.5,000 at 98.00/- (cum interest)

Aug. 1 Rs. 10,000 at 100.25/- (cum interest)

Dec. 15 Rs. 2,500 at 98.50/- (ex-interest)

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

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

Solution: Illustration 2

Working Note:

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Date	Face Value	Purchase Price (₹)	Amount Paid (₹)	Interest	Ex-Interest
Mar -1	5,000	98	4,900 (Cum)	50 (5,000 × 6% × 2/12)	4,850
Aug - 1	10,000	100.25	10,025 (Cum)	50 (10,000 × 6% × 1/12)	9,975
Dec - 15	2,500	98.5	2531.25	68.75 (2,500 × 6% × 5.5/12)	2,462.5

6% Debentures (1st Half)

Date	Particulars	Debit ₹	Date	Particulars	Credit ₹
1st March	To Bank	4,850	Jan. 1	By Balance b/d	50,000
1st March	To Profit on Cancellation	150			
30th June	To Balance c/d	45,000			
		50,000			50,000

Interest on Debentures (1st Half)

Date	Particulars	Debit ₹	Date	Particulars	Credit ₹
1st March	To Bank	50	30th June	By Profit and Loss	1,400
30 June	To Bank A/c	1,350			
		1,400			**1,400**

6% Debentures (2nd Half)

Date	Particulars	Debit ₹	Date	Particulars	Credit ₹
1st Aug	To Bank	9,975	Aug. 1	By Balance b/d	45,000
1st Aug	To Profit on Cancellation	25			
15th Dec	To Bank	2,462.5			
15th Dec	To Profit on Cancellation	37.5			
31st Dec	To Balance c/d	32,500			
		45,000			**45,000**

Interest on Debentures (2nd Half)

Date	Particulars	Debit ₹	Date	Particulars	Credit ₹
1st Aug	To Bank A/c	50	30th June	By Profit and Loss	1093.75
15th Dec	To Bank A/c	68.75			

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31st Dec	To Bank A/c	975			
		1093.75			**1093.75**

Illustration – 3

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

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

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

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

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

Debenture Holders Account.

Solution: Illustration 3

12% Debenture Account

Date	**Particulars**	**₹**	**Date**	**Particulars**	**₹**
31-03-X2	To Debenture Holders A/c	7,50,000	1-4-X1	By Balance b/d	7,50,000
		7,50,000			**7,50,000**

DRR Account

Date	**Particulars**	**₹**	**Date**	**Particulars**	**₹**
			1-4-X1	By Balance b/d	25,000
31-03-X2	To General reserve A/c	75,000	1-4-X1	By Profit & Loss A/c (75,000 -25,000) WN1	50,000
		75,000			**75,000**

DRR Investment Account (10% GOI Bonds)

Date	**Particulars**	**₹**	**Date**	**Particulars**	**₹**
1-4-X1	To Balance b/d	1,12,500	31-03-X2	By Bank	1,12,500

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		1,12,500			**1,12,500**

Bank Account

Date	Particulars	₹	Date	Particulars	₹
31-03-X2	To Balance b/d	7,50,000	31-03-X2	By Debenture holders A/c	8,25,000
31-03-X2	To Interest on DRR Investment (10% × ₹100 × 1,125)	11,250		By Interest on Debentures	90,000
	To DRR Investment A/c	1,12,500			
31-03-X2	To balance c/d	41,250			
		9,15,000			**9,15,000**

Debenture Holders Account

Date	Particulars	₹	Date	Particulars	₹
			31-03-X2	By 12% Debentures	7,50,000
31-03-X2	To Bank A/c	8,25,000		By Premium on redemption of debentures (7,50,000 × 10%)	75,000
		8,25,000			**8,25,000**

Working Note:

1. Closing balance required in DRR (10% of 7,50,000) = 75,000

Illustration – 4

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

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

The purchase details are:

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

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

(i) Debentures Account and

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(ii) Own Debenture (Investment) Account.

Ignore Taxation.

Solution: Illustration 4

5% Debentures A/c (20X2)

Date	Particulars	Amount	Date	Particulars	Amount
Mar 1	To Own Debenture Investment	24,725	Jan 1	By Balance b/d	1,50,000
	To Gain on Cancellation (25,000 – 24,725)	275			
Sep 1	To Own Debenture Investment	19,708			
	To Gain on Cancellation (WN)	292			
Sep 1	To Balance c/d	1,05,000			
		1,50,000			**1,50,000**

Own Debenture Investment A/c (20X2)

Date	Particulars	Face Value	Interest	Cost	Date	Particulars	Face Value	Interest	Cost
1/3	To Bank	25,000	521	24,725	1/3	By 5% Debentures A/c	25,000	-	24,725
1/9	To Bank (WN)	20,000	417	19,708	1/9	By 5% Debenture A/c	20,000	-	19,708
					1/9	By P&L		938	
		45,000	**938**	**44,433**			**45,000**	**938**	**44,433**

Working Note

Date	Face Value (Nominal Value)	Amount Paid	Interest	Ex- Interest
1/03/21	25,000	25,246	521 (25,000 × 5% × 5/12)	24,725
Gain on Cancellation				**275**
1/9/X2	20,000	20,125	417 (20,000 × 5% × 5/12)	19,708
Gain on Cancellation				**292**

Illustration – 5 : Deleted

Illustration – 6

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

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Share Capital:		Freehold property	1,15,000

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

At the Annual General Meeting, it was resolved:

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

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

Solution: Illustration 6

Working Notes:

1) Rights Issue

Number of Rights shares to be issued- (20,000 shares / 4) X 1 = 5,000 shares @ ₹15 (Face Value @₹10 + ₹5 towards premium)

2) No. of Bonus Shares

Number of Bonus shares to be issued- (25,000 shares / 5) X 1 = 5,000 bonus shares

Journal of BEE Co. Ltd

Particulars		**Dr. (₹)**	**Cr. (₹)**
Bank A/c	Dr.	75,000	
To Equity Shareholders A/c			75,000
(Being amount collected from equity shareholders @₹15 per share for 5,000 right shares)			
Equity Shareholders A/c	Dr.	75,000	
To Equity Share Capital A/c			50,000
To Securities Premium A/c			25,000

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(Being right shares issued to the shareholders @₹15. ₹10 accounted as Share Capital and ₹5 accounted as securities Premium)			
Securities Premium A/c Profit & Loss A/c To Bonus to Shareholder's A/c (Being amount transferred for issue of Bonus Share)	Dr. Dr.	25,000 25,000	 50,000
Bonus to Shareholders A/c To Equity Share Capital A/c (Being 5000 Bonus Shares issued @1 share for every 5 shares held)	Dr.	50,000	 50,000
Profit and Loss A/c To Debenture Redemption Reserve (Being DRR created at 10% of debentures redeemed)	Dr.	12,000	 12,000
Debenture Redemption Reserve Investment A/c To Bank A/c (Being DRR Investment created 15% x 1,20,000 as per the provisions)	Dr.	18,000	 18,000
12% Debentures A/c Premium on Redemption of Debentures A/c To Debenture Holders a/c (Being amount payable to Debenture holders)	Dr. Dr.	1,20,000 3,600	 1,23,600
Debenture holders a/c To Bank A/c (Being Amount repaid to debenture holders)	Dr.	1,23,600	 1,23,600
DRR A/c To General Reserve A/c (Being DRR balance transferred to General Reserve after redemption of debentures)	Dr.	12,000	 12,000
Bank A/c To DRR Investment (Being DRR investment Realised at par)	Dr.	18,000	 18,000

Balance Sheet of BEE Co. Ltd. As on ..... (after completion of transactions)

Particulars	**Note No**	**₹**
I. Equity and liabilities		
(1) Shareholder's Funds		
(a) Share Capital	**1**	3,00,000
(b) Reserves and Surplus	**2**	91,400
(2) Current Liabilities		
(a) Trade payables		1,15,000
Total		**5,06,400**
II. Assets		
(1) Non-current assets		

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(a) Property, Plant and Equipment		
(i) Tangible Assets	**3**	1,15,000
(2) Current assets		
(a) Inventories		1,35,000
(b) Trade receivables		75,000
(c) Cash and bank balances	**4**	1,81,400
Total		**5,06,400**

Notes to Accounts

1	**Share Capital** 30,000 shares of ₹10 each fully paid (5,000 shares of ₹10 each, fully paid issued as bonus shares out of securities premium and P&L Account)		**3,00,000**
2	**Reserve and Surplus**		
	Profit & Loss Account	1,20,000	
	Less: Utilisation for issue of bonus shares	(25,000)	
	Less: DRR created	(12,000)	
	Less: Premium on Redemption	(3,600)	
		79,400	
	General Reserve	12,000	91,400
3	**Tangible assets**		
	Freehold property		1,15,000
4	**Cash and bank balances**		
	Cash at bank (2,00,000 + 75,000 – 1,23,600)	1,51,400	
	Cash in hand	30,000	1,81,400

Notes:

Closing Balances after Transaction

Account	**Opening**	**Additions**	**Deletions**	**Closing Balance**
Cash& Bank	2,00,000	75,000 18,000	18,000 1,23,600	1,51,400
Equity Share Capital	1,20,000	50,000 + 50,000		3,00,000
Securities Premium	0	25,000	25,000	0
Profit & Loss	1,20,000		25,000 12,000 3,600	79,400
DRR	30,000	12,000	12,000	0
DRR Investment		18,000	18,000	0
12% Debentures	1,20,000		1,20,000	0
General Reserve	-	12,000	-	12,000

Illustration – 7

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

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Particulars	Amount (Rs.)
Liabilities:	
Share Capital: 5,00,000 equity shares of Rs. 10 each fully paid	50,00,000
General Reserve	75,00,000
Profit And loss A/c	10,00,000
Debenture Redemption Reserve	25,00,000
13.5% Convertible Debentures, 1,00,000 Debentures of Rs. 100 each	1,00,00,000
Other loans	65,00,000
Current Liabilities and Provisions	1,25,00,000
	4,50,00,000

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

Assuming that:

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

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

Solution: Illustration 7

Working Notes :

1) Calculation of number of shares to be allotted:

Total number of debentures	1,00,000
Less: Number of debentures for which debenture holders did not opt for conversion	(25,000)
	75,000
20% of 75,000 opt for conversion as in the form equity shares (Redemption)	15,000
Redemption value of 15,000 debentures (15,000x105)	₹15,75,000
Therefore No. of equity shares to be issued (15,75,000/15.75)	1,00,000 equity shares

2) Computation of cash to be Paid

Total number of debentures	1,00,000
Less: Converted to Equity	15,000
To be Paid (Cash/Bank) in Number of Deb. holders	85,000
Total amount to be Paid (85,000 × 105)	₹89,25,000

Convertible Limited Balance Sheet as on July 1,20X1

Particulars	Note No	₹ in Lakhs
I. Equity and liabilities		

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(1) Shareholder's Funds		
(a) Share Capital	**1**	60
(b) Reserves and Surplus	**2**	110.75
(2) Non - Current Liabilities		
(a) Long-term borrowings	**3**	65
(3) Current Liabilities		
(a) Short-term provisions		125
Total		**360.75**
II. Assets		
(1) Non-current assets		
(a) Property, Plant and Equipment		
(i) Tangible Assets		160
(2) Current assets		
(a) Cash and bank balances	**4**	0.75
(b) Other current assets		200
Total		**360.75**

[Text Wrapping Break]**Notes to Accounts**

(In Lakhs)

1	**Share Capital** Authorised, issued and Subscribed (5,00,000 + 1,00,000) 6,00,000 @₹10 (Refer WN (1))		60
2	**Reserve and Surplus** General Reserve Add: Transfer from DRR Profit & Loss Less: Premium on Redemption Securities Premium	 75 25 10 (5)	 100 5 5.75
			110.75
3	**Long Term Borrowings** Secured Loans		65
4	Cash and bank balances Add: DRR Investment Less: Debenture Holder Payment	75 15 90 (89.25)	 0.75

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UNIT 7 - UNDERWRITING OF SHARES

OBJECTIVES:

I. About Underwriting

II. Provisions of Companies Act 2013 relating to it

III. Types of underwriting contracts

IV. Concept of marked / unmarked applications, and determining liability of underwriters

V. Accounting entries

UNDERSTANDING UNDERWRITING:

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

Problems of undersubscription

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

Primary Objective of underwriting

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

Underwriter could be an individual, partnership or company

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

Prominent institutional underwriters

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

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RELEVANT PROVISIONS OF COMPANIES ACT 2013:

A. Underwriting commission

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

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

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

B. Disclosure requirements

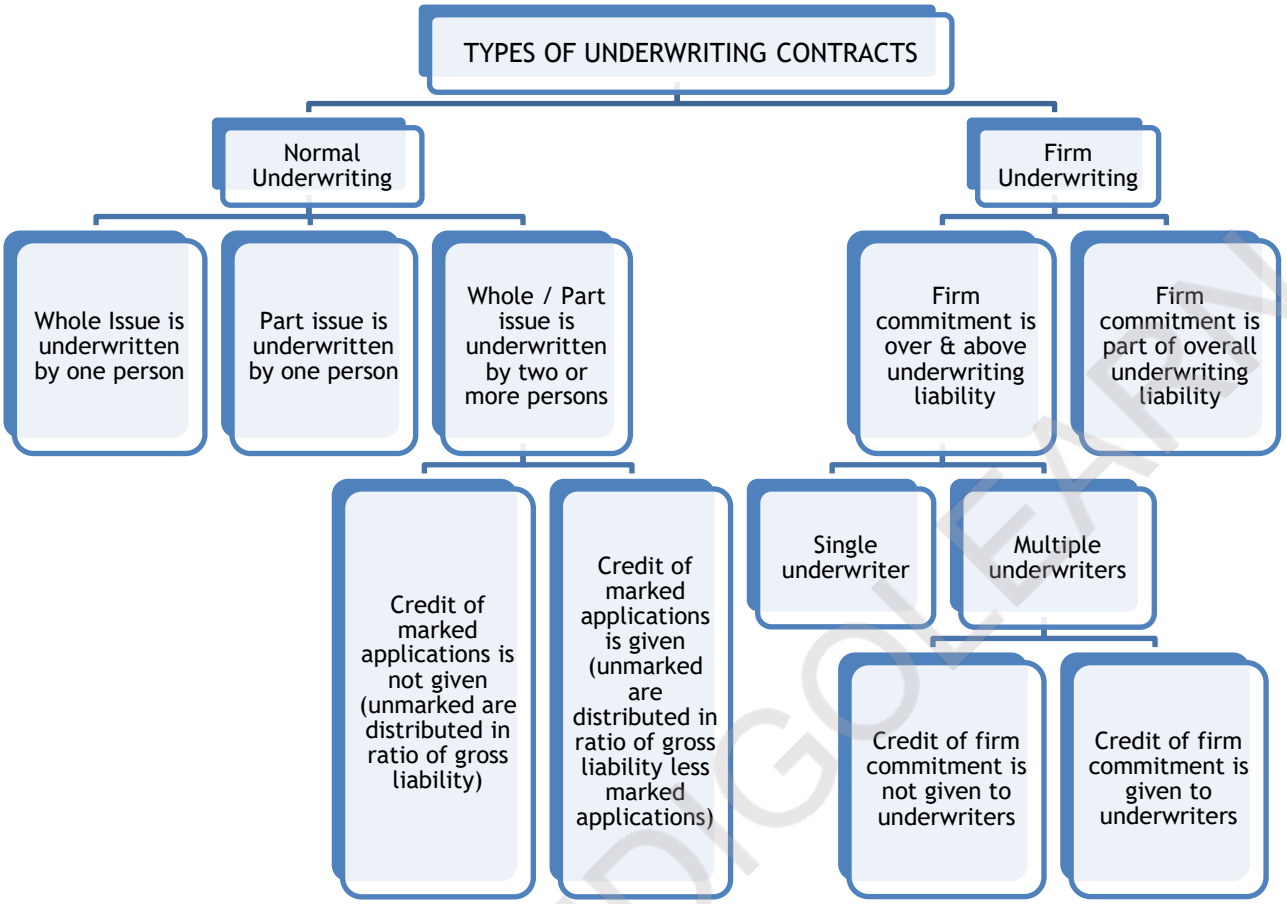
4. Names of underwriters must be disclosed in the Prospectus, alongwith the opinion of the directors that the resources of the underwriters are sufficient to discharge their obligations

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

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

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TYPES OF UNDERWRITING CONTRACTS:



DETERMINING LIABILITY UNDER VARIOUS TYPES OF UNDERWRITING CONTRACTS:

CONCEPT OF MARKED APPLICATIONS

1. Company issues share applications to offer to public for being able to subscribe to its shares.
2. Underwriters also make an effort to promote and maximize subscription.
3. Applications distributed by underwriters are marked (with a code or underwriter name or any such distinguishing feature) so that when those applications are submitted, they are clearly distinguishable.
4. The purpose of such marking of applications and thereby separating them from others (unmarked applications), will be clear below, as we understand how is the liability of underwriters determined.

DETERMINING LIABILITY OF UNDERWRITERS

A. NORMAL UNDERWRITING

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

1. Whole issue is underwritten by one person

Assume X underwrites all 10,000 shares

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

2. Part issue is underwritten by one person

Assume X underwrites 6,000 shares

Scenario / Fact pattern	Explanation	X's liability
Issue is oversubscribed **Company receives 11,000 applications** **5,000 marked** **6,000 unmarked**	Issue size 10,000 Unmarked applic (6,000) Thus, Gross liab of X 4,000 Marked applic (5,000) Hence, shortfall Nil	Nil
Issue is undersubscribed **Company receives 9,000 applications** **4,000 marked** **5,000 unmarked**	Issue size 10,000 Unmarked applic (5,000) Thus, gross liab of X 5,000 Marked applic (4,000) Hence, shortfall 1,000 X agreed for 6,000 and marked were 4,000. Thus, shortfall of 1,000 to be met by X	1,000 applications
Issue is undersubscribed **Company receives 9,000 applications** **7,000 marked** **2,000 unmarked**	Issue size 10,000 Unmarked applic (2,000) Thus, gross liab of X 8,000 Marked applic (7,000) Hence, shortfall 1,000 X agreed for 6,000 and marked were 7,000. Thus, X CANNOT be asked to meet the shortfall	Nil

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

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

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

Liability will be determined as Gross Liability

Less: Marked applications

Less: Unmarked applications

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

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

	X	Y	Z
Gross liability as underwritten	4,000	3,500	2,500
Less: Unmarked applications In the ratio 40:35:25	(1,200)	(1,050)	(750)
Adjusted gross liability	2,800	2,450	1,750
Marked applications (actuals)	(2,000)	(1,000)	(2,000)
Balance	800	1,450	(250)
Credit for Z's surplus to X and Y In the ratio 40:35	(133)	(117)	250
Actual liability	**667**	**1,333**	**-**

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

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

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

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

B. FIRM UNDERWRITING

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

Example:

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

Now, there could be two types of arrangements:

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

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

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

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

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

SINGLE UNDERWRITER

Total issue	10,000
Less: Applications received	8,000

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

MULTIPLE UNDERWRITERS

Liability will be determined as:

	A	B	C
Gross Liability	XXX	XXX	XXX
Less: Marked applications excluding firm underwriting	(XX)	(XX)	(XX)
Less: Unmarked applications (See Working Note 1)			
in ratio of gross liability	(XX)	(XX)	(XX)
(Surplus) / Deficit	XXX	XXX	(XX)
Less: Negative applications of C			
in ratio of A & B's gross liability	(XX)	(XX)	XX
Net liability (See Working Note 2)	XXX	XXX	--
Add: Firm underwriting	XX	XX	XX
Total liability	**XXX**	**XXX**	**XXX**

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

Working Note 1: Determining total number of unmarked applications

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

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

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

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

Working Note 1: Determining total number of unmarked applications

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

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

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

ACCOUNTING ENTRIES:

For shares taken up by underwriters

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

1. **For underwriting commission due**

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

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

Bank Dr.
To Underwriter A/c

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Illustration – 1

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

The entire issue was underwritten as follows:

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

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

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

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

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

X – 15,000 shares

Y – 30,000 shares

Z – 75000 shares

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

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

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

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

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

(Source ICAI)

Illustration 2

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

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

Their firm underwriting was as follows :

X 30,000 shares,

Y 20,000 shares and

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Z 10,000 shares.

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

Marked applications were as follows:

X 1,19,500 shares,

Y 57,500 shares and

Z 10,500 shares.

Unmarked applications totaled 7,00,000 shares. Accounts with the underwriters were promptly settled.

You are required to:

i. Prepare a statement calculating underwriters' liability for shares other than shares underwritten firm
ii. Pass journal entries for all the transactions including cash transactions.

Illustration 3

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

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

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

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

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

(Source ICAI)

Illustration 4

Gemini Ltd. came up with public issue of 30,00,000 Equity shares of ₹10 each at ₹ 15 per share. A, B and C took underwriting of the issue in 3 : 2 : 1 ratio.
Applications were received for 27,00,000 shares. The marked applications were received as under:

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

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

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

Illustration 5

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

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

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

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

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

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

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Illustration 6

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

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

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

Pass summary journal entries for —

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

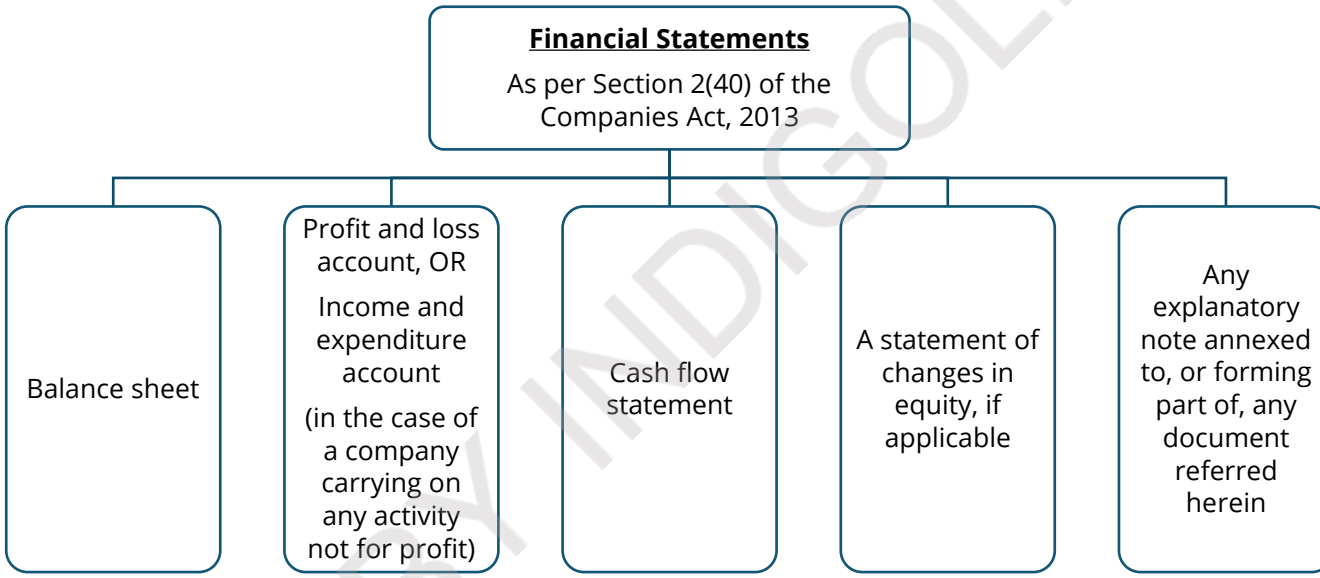
   Note: Unmarked applications are to be credited to underwriters equally. Benefit of firm underwriting is given to individual underwriter.

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CHAPTER 2 – PREPARATION OF FINANCIAL STATEMENTS

FINAL ACCOUNTS

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

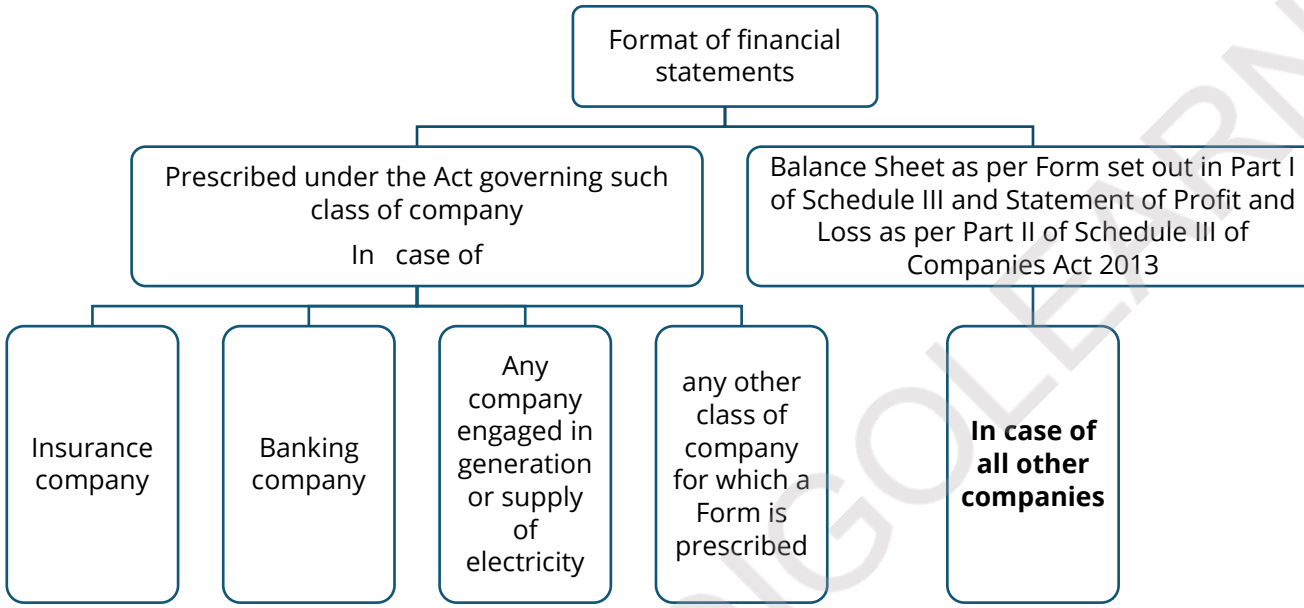


The financial statement, with respect to One Person Company, Small company and Dormant company, does not include the cash flow statement.

- **Objective of financial statements -** It should give a true and fair view of the state of affairs of the company as at the end of the financial year.
- **Points to be kept in mind while preparing final accounts**
  - Requirements of Schedule III to the Companies Act
  - Other statutory requirements;
  - Accounting Standards notified by Ministry of Corporate Affairs (MCA)(AS 1 to AS 29);
  - Statements and Guidance Notes issued by the Institute of Chartered Accountants of India (ICAI); which are necessary for understanding the accounting treatment/ valuation/ disclosure suggested by the ICAI

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

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Rounding off Requirement

Total Income	Rounding off
< 100 crores	Nearest hundreds, thousands, lakhs, millions or decimals thereof
>= 100 crores	to the nearest lakhs, millions, or crores or decimals thereof

PART-I – FORM OF BALANCE SHEET

Name of the Company: .....

Balance Sheet as at: .....

Sr.No.	Particulars	Note no.	Figure as at the end of Current reporting Period	Figures as at the end of the Previous Reporting Period
I	**Equity and Liabilities**			
1	Shareholders' Funds			
	(a) Share Capital (b) Reserves & Surplus (c) Money received against Share Warrants			

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2	Share application money pending allotment			
3	Non-Current liabilities			
	(a) Long-term Borrowings (b) DTL (Net) (c) Other long-term liabilities (d) Long-term Provisions			
4	Current liabilities			
	(a) Short-term Borrowings (b) Trade Payables (c) Other Current liabilities (d) Short-term Provisions			
	TOTAL			
II	**Assets**			
1	Non-Current assets			
	(a) PPE (property, plant & Equipment) & Intangible Assets (i) Property, Plant and Equipment (ii) Intangible assets (iii) Capital WIP (iv) Intangible assets under development			
	(b) Non-Current investments (c) Deferred tax assets (DTA) (Net) (d) Long-term loans & advances (e) Other Non-Current assets			\
2	Current assets			
	(a) Current investments (b) Inventories (c) Trade receivables (d) Cash & Cash equivalents (e) Short-term loans & advances (f) Other Current assets			
	TOTAL			

DISCLOSURE REQUIREMENTS IN RESPECT OF BALANCE SHEET

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

1. **SHARE CAPITAL**

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(a) Authorized Capital – to be shown separately

- It is the maximum number and face/par value, of each class of shares that a corporate entity may issue in accordance with its instrument of incorporation.
- Face/Par Value, as per Capital Clause in Memorandum of association should be disclosed.
- Separate disclosure for both Equity and Preference Shares.

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

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

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

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

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

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

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

- If during the year, any Shareholder held more than 5% equity Shares but does not hold as much at the Balance Sheet date, disclosure is not required.
- Companies should disclose the Shareholding for each class of Shares, both within equity and Preference Shares. So, such% should be computed separately for each class of Shares.
- This information should also be given for comparative previous period.

(g) Shares reserved for issue under Options and Contracts/ commitments for the sale of Shares/ disinvestment, including the terms and amounts

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- Shares under Options generally arise under Promoters or Collaboration agreements, loan agreements or debenture deeds (including Convertible debentures), agreement to convert Preference Shares into equity Shares, ESOPs or Contracts for supply of Capital Goods, etc.
- Disclosure is required for the Number of Shares, amounts and Other terms for Shares so reserved.
- Such options are in respect of unissued Portion of Share Capital

(h) For the period of 5 years immediately preceding the date as at which the Balance Sheet is prepared-

• Aggregate Number & Class of Shares allotted as Fully Paid and up Pursuant to Contract(s) without payment being received in Cash

• Aggregate No. and Class of Shares allotted as fully Paid up by way of Bonus Shares

• Aggregate Number & Class of Shares bought back

- Disclose only if such event has occurred during a period of 5 years immediately preceding the Current year Balance Sheet date
- If the company is in operation for a period of less than 5 years, then disclosure should cover all such earlier financial years
- The following allotments are considered as Shares allotted for payment being received in cash, and hence should not be disclosed under this Clause –
  (a) If the subscription amount is adjusted against a bonafide debt payable in money at once by the Company,

(b)Conversion of loan into Shares in the event of default in repayment

(i) Terms of any Securities Convertible into Equity / Preference Shares issued along with the earliest date of conversion in descending order starting from the farthest such date.

- In case of Compulsorily Convertible Securities, where conversion is done in fixed tranches, all the dates of conversion have to be considered.
- In case of Convertible Debentures/Bonds, etc., for the purpose of simplification, reference may also be made to the terms disclosed under the note on long term Borrowings where these are required to be classified in the Balance Sheet, rather than disclosing the same against under this Clause.

(j) Calls Unpaid (showing aggregate value of Calls Unpaid by Directors and Officers)

- Unpaid amount towards Shares subscribed by the Subscribers of Memorandum of association should be considered as 'Subscribed and paid-up Capital' in the Balance Sheet and the debts due from the Subscribers should be appropriately disclosed as an asset in the B/Sheet.

(l) Forfeited Shares (amount originally paid up)

(m) Shares held by promoters at the end of year

Name of Promoter	No of Shares	% of total shares	% change during the year

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2. RESERVES & SURPLUS

Reserves & Surplus shall be classified as –
(a) Capital reserves
(b) Capital redemption reserve
(c) Securities Premium
(d) Debenture redemption reserve
(e) Revaluation reserve
(f) Share Options Outstanding account
(g) Other reserves
(h) Surplus, i.e., balance in Statement of P&L disclosing allocations & appropriations, such as, dividend, Bonus Shares and transfer to/from reserves, etc.

- Additions & deductions since last Balance Sheet to be shown under each of specified heads.
- Appropriations to the Profit for the year (including carried forward balance) is to be presented under the main head 'Reserves and Surplus'.
- Under Sch III, the Statement of P&L will no longer reflect any appropriations, like Dividends transferred to reserves, Bonus Shares, etc.
- A Reserve specifically represented by Earmarked Investments shall be termed as a 'Fund'.
- Debit Balance Statement of P&L shall be shown as a Negative Figure under the head 'Surplus'. Similarly, the balance of 'reserves & Surplus', after adjusting Negative balance of Surplus, if any, shall be shown under the head 'Reserves & Surplus' even if the resulting figure is in the negative.

- **Capital Reserve -** It is a Reserve of a Corporate enterprise which is not available for distribution as dividend.

Profit on Re-issue of Forfeited Shares is basically profit of a Capital Nature and, hence, it should be credited to Capital reserve.

- **Capital redemption reserve (CRR)** is required to be created u/s 55 and 68 (for redemption of Preference Share Capital and buyback of Equity Share Capital), subject to conditions specified in the respective Sections.
- **Debenture Redemption Reserve (DRR)** is required to be created u/s 71, and maintained until such debentures are redeemed. On redemption of the debentures, the amounts no longer necessary to be retained in this account should be transferred to the General reserve.
- **Revaluation reserve** is a reserve created on the revaluation of assets or Net assets of an enterprise represented by the surplus of the estimated Replacement Cost or estimated market values over the Book Values thereof.
- As per ICAI Guidance Note on ESOP, **Share Options Outstanding** should be shown as separate line item. Under Schedule III, this line item should be shown separately under reserves & Surplus.
- **Other reserves** - This includes any other Statutory reserves, e.g. tonnage tax reserve to be created under the income tax act, 1961.

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3. MONEY RECEIVED AGAINST SHARE WARRANTS

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

4. SHARE APPLICATION MONEY PENDING ALLOTMENT

- Share application Money not exceeding the issued capital and to the extent not refundable is to be disclosed as a separate line item after "Share Holders Funds" and before "Non-Current Liabilities".
- If the Company's issued Capital is more than the authorized Capital, and approval of increase in authorized Capital is pending, the amount of Share application Money received over and above the authorized Capital should be shown under the head "Other Current Liabilities".
- The amount shown as 'Share application Money Pending allotment' will not include Share application Money to the extent refundable, for example, the amount in excess of issued Capital, or where Minimum Subscription requirement is not met. Such amount will have to be shown separately under 'Other Current liabilities.
- Calls Paid in Advance are to be shown under "Other Current liabilities". the amount of interest which may accrue on such advance should also is to be reflected as a liability.

5. NON-CURRENT LIABILITIES

(A) LONG-TERM BORROWINGS

Long-Term Borrowings shall be classified as –

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

1. Definitions and Meanings:

- Loans with repayment period beyond 36 months are usually known as "**Term Loans**". So, Cash Credit, Overdraft and Call Money accounts/ deposits are not covered by the expression "Term Loans".
- **Deferred Payment liabilities** would include any liability for which payment is to be made on deferred credit terms, e.g., Deferred Sales tax liability, Deferred Payment for Acquisition of fixed Assets, etc.
- **Deposits** classified under Borrowings would include deposits accepted from Public and inter-Corporate deposits which are in the nature of Borrowings.

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- **Loans and advances** from related parties are required to be disclosed. advances under this head should include those advances which are in the nature of loans.

2. Security-wise Classification:

- Borrowings shall further be sub-classified as Secured and Unsecured. Nature of Security shall be specified separately in each case.
- However, where one security is given for multiple loans, the same may be clubbed together for disclosure purposes with adequate details of cross referencing.
- Disclosure about the nature of security should also cover the type of asset given as security, e.g., Inventories, Plant and Machinery, land and Building, etc.
- When Promoters, other Shareholders or any third party have given any personal security for any borrowing, e.g., Shares or Other assets held by them, disclosure should be made thereof, though such security does not result in the classification of such borrowing as secured.

3. Guarantees:

- Where loans have been guaranteed by directors or Others, the aggregate amount of such loans under each head shall be disclosed.
- Others" would mean any Person or entity other than a director, e.g., related Parties, or any person associated with the Company in some manner.

4. Maturity Date wise:

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

5. Installment redemption:

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

6. Power to reissue:

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

7. Terms of repayment:

- Repayment of term loans and Other loans shall be stated.

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

8. Continuing Default:

- Period and amount of continuing default as on the Balance Sheet date in repayment of loans and interest, shall be specified separately in each case.
- The term "Continuing Default" is used w.r.t. Long Term Borrowings, whereas the term "Default" is used w.r.t. Short-term borrowings.
- Under CARO, the Auditor shall report on the default made and the period of default.
- Defaults other than in respect of repayment of loan and interest, e.g., non-compliance with debt Covenants, etc., need not be disclosed.
- Any default that had occurred during the year and was subsequently made good before the end of the year need not be disclosed.

(B) DEFERRED TAX LIABILITIES

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

(C) OTHER LONG-TERM LIABILITIES

It shall be classified as –

(a) Trade Payables

(b) Others

- Sundry Creditors for Goods or Services, and acceptances should be disclosed as part of trade Payables.
- Disclosure requirements under Micro, Small & Medium enterprises development (MSMED) act will also be required to be made in the annual Financial Statements.
- Amounts due under contractual obligations, e.g., payables in respect of statutory obligations, like contribution to Provident Fund, Purchase of Fixed assets, Contractually reimbursable expenses, interest accrued on trade Payables, etc., should be classified as "Others" and each such item should be disclosed nature wise.

(D) LONG-TERM PROVISIONS

It shall be classified as –

(a) Provision for Employee Benefits

(b) Others (Specifying nature)

- This should be classified into short-term and long-term portions, and the latter amount should be included here.
- "Others" would include items like Provisions for Warranties.

(6) CURRENT LIABILITIES

(A) SHORT-TERM BORROWINGS

Short-Term Borrowings shall be classified as –

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(a) Loans Repayable on demand– (i) from Banks, & (ii)Other Parties,
(b) Loans and Advances from Related Parties,
(c) Deposits,
(d) Other Loans and Advances (specify nature)
(e) Current maturity of long term borrowings

1. Definition & meaning:

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

2. Security wise Classification:

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

3. Guarantees:

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

4. Default:

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

(B) TRADE PAYABLES

It shall be classified as –
(a) Total outstanding dues of micro enterprises and small enterprises; and
(b) Total outstanding dues of creditors other than micro enterprises and small enterprises."

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

The following details relating to Micro, Small and Medium enterprises shall be disclosed in the notes:

(a) the principal amount and the interest due thereon (to be shown separately) remaining unpaid to any supplier at the end of each accounting year;
(b) the amount of interest paid by the buyer along with the amount of the payment made to the supplier beyond the appointed day during each accounting year;

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(c) The amount of interest due and payable for the period of delay in making payment (which have been paid but beyond the appointed day during the year) but without adding the interest specified under the Micro, Small and Medium enterprises development act, 2006;
(d) the amount of interest accrued and remaining unpaid at the end of each accounting year; and
(e) the amount of further interest remaining due and payable even in the succeeding years, until such date when the interest dues above are actually paid to the small enterprise, for the purpose of disallowance of a deductible expenditure under Section 23 of the Micro, Small and Medium enterprises development act, 2006.

Ageing Schedule

Particulars	Outstanding for a period				Total
	<1 Year	1-2 Years	2-3 years	>3 Years	
MSME					
Others					
Disputed – MSME					
Disputed - Others					

(C) OTHER CURRENT LIABILITIES

It shall be classified as –

- Current Maturities of Finance lease Obligations,
- interest accrued but not due on Borrowings,
- interest accrued and due on Borrowings,
- income received in advance,
- unpaid dividends,
- application Money received for allotment of Securities and due for refund and interest accrued thereon
- unpaid Matured deposits and interest accrued thereon,
- unpaid Matured debentures and interest accrued thereon,
- Other Payables (specify nature).

- The portion of Long-Term Debts/ Lease Obligations, which is due for payments within 12 months of the reporting date is required to be classified under "Other Current Liabilities", while the balance amount should be classified under long-term Borrowings.
- Trade Deposits and Security Deposits which are not in the nature of Borrowings should be

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classified separately under Other Non-Current/ Current liabilities.

- 'Other Payables' under this head may be in the nature of statutory dues such as withholding taxes, Service tax, VAT, Excise duty, etc.
- Current/Non-current Classification of Assets / Liabilities is determined on a particular date, i.e., Balance Sheet date. So, if there is any change in the position at the end of the current year resulting in a different classification of Assets / Liabilities in the current year, it will not impact the classification made in the previous year.

(D) SHORT TERM PROVISIONS

It shall be classified as –
(a) Provision for Employee Benefits
(b) Others (Specifying nature)

- This should be classified into short-term and long-term portions, and the former amount should be included here.
- "Others" includes Provision for dividend, Provision for taxation, Provision for Warranties, etc.

(1) NON-CURRENT ASSETS

(A) (I) TANGIBLE ASSETS

1. Classification shall be given as –
(a) Land, (b) Buildings, (c) Plant and equipment, (d) Furniture & Fixtures, (e) Vehicles, (f) Office Equipment, (g) Others (Specify Nature).

- **AS-19** excludes land leases from its scope. Leasehold land should be presented as a separate assets class under Tangible Assets. Also, Freehold land should be presented as a separate asset class.
- Assets under Lease shall be separately specified under each class of asset. The term "under lease" should mean –
  - Assets given on Operating lease in the case of lessor, and
  - Assets held under Finance lease in the case of lessee.
- Leasehold Improvements should continue to be shown as a separate asset class.
- **AS-10** requires disclosure of details such as Gross Book Value of Revalued Assets, Method adopted to compute revalued amounts, Nature of indices used, year of appraisal, involvement of external valuer, etc. as long as the concerned assets are held by the Enterprise. [But only 5 years period is specified in Sch III. AS-10 requirements will prevail.]
- **AS-26** does not permit revaluation of intangible assets.
- Since reconciliation of Gross and Net Carrying amounts of Fixed assets is required, the depreciation/ Amounts of fixed assets is required, the Depreciation/ amortization for each class of asset should be disclosed in terms of –

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- Opening Accumulated Depreciation,
- Depreciation/Amortization for the year,
- Deductions/Other Adjustments, and
- Closing Accumulated Depreciation/ Amortization

➢ Similar disclosures should also be made for impairment, if any, as applicable.

➢ **Business Combinations**: Business Combination should be taken as an amalgamation or acquisition or any other mode of restructuring of a set of assets and/or a group of assets and liabilities constituting a business.

➢ Acquisitions through 'Business Combinations' should be disclosed separately for each class of assets.

➢ Asset Disposals through Demergers, etc., if any also be disclosed separately for each class of assets.

➢ **Other Adjustments**: This includes –

- Capitalization of FOREX Differences where such option has been exercised by the Company as per **AS-11**.
- Adjustments on a/c of Exchange Fluctuations for Fixed assets in case of Non-integral Operations (AS11).
- Borrowing Costs capitalized as per **AS-16**.

(A) (II) INTANGIBLE ASSETS

Classification shall be given as –

(a) Goodwill, (b) Brands / Trademarks, (c) Computer Software, (d) Mastheads and Publishing titles, (e) Mining rights, (f) Copyrights, and Patents and Other intellectual Property rights, Services and Operating rights, (g) recipes, Formula, Models, designs and Prototypes, (h) licenses and Franchise, (i) Others (specify nature).

➢ Intangible assets under development should also be disclosed separately, if aS-26 criteria are met.

(A) (III) CAPITAL WORK IN PROGRESS

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

➢ Capital advances should be included under long term loans and advances and hence, cannot be included under Capital WIP.

(A) (IV) INTANGIBLE ASSETS UNDER DEVELOPMENT

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

(B) NON CURRENT INVESTMENTS

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

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(a) Property,
(b) Equity instruments,
(c) Preference Shares,
(d) Government / trust Securities,
(e) Debentures or Bonds,
(f) Mutual Funds,
(g) Partnership Firms, and
(h) Other Non-Current investments (specify nature).

- If a Debenture is to be redeemed partly within 12 months and balance again after 12 months, the amount to be redeemed within 12 months should be disclosed as current, and balance as Non-Current.
- "Trade Investment" is normally understood as an investment made by a Company in Shares or debentures of another Company, to promote the trade or business of the first Company.
- Under each classification, details shall be given about
- The names of Bodies Corporate (indicating separately whether such bodies are –

Subsidiaries, (ii) associates, (iii) Joint Ventures, or (iv) Controlled Special Purpose entities) in whom investments have been made and

- The nature and
- Extent of the investment so made in each such Body Corporate (showing separately investments which are partly-paid).
- "Nature and Extent" of Investment in each Body Corporate should be interpreted to mean the number and face value of Share.
- Also, it is advisable to clearly disclose whether investments are fully paid or partly paid. (itemwise)
- With regard to investments in the capital of Partnership Firms, the Names of the Firms (with the names of all their Partners, total Capital and the Shares of each Partner) shall be given.
- Investments in LLPs will be disclosed separately under "Other Investments".
- In case of change in constitution of the Firm during the year, the names of the other partners should be disclosed based on the position existing as on the date of Company's Balance sheet.
- Investments carried at other than at Cost should be separately stated specifying the basis for valuation thereof.
- Basis could be (a) Cost, or (b) Cost less Provision for other than temporary diminution, or

(c)Lower of Cost and Fair Value.

- The following shall also be disclosed- (a) aggregate amount of Quoted investments and Market Value thereof, (b) Aggregate Amount of unquoted investments, (c) aggregate Provision for diminution in value of investments.

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(1) (C) DEFERRED TAX ASSET

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

(1) (D) LONG TERM LOANS AND ADVANCES

1. **General Classification**: Long-term loans and advances shall be classified as –
(a) Capital advances,
(b) Security deposits,
(c) Loans and advances to related Parties (giving details thereof),
(d) Other loans and advances (specify nature)

- Capital Advances are advances given for procurement of Fixed assets which are Non-Current Assets. They are not realized back in cash, and over a period, get converted into Fixed assets.
- Other loans and Advances should include all other items in the nature of advances recoverable in cash or kind, e.g., Prepaid Expenses, Advance Tax, CENVAT Credit receivable, VAT Credit receivable and Service tax Credit receivable which are not expected to be realized within the next 12 months or operating cycle whichever is longer, from the Balance Sheet date.

2. **Security wise Classification**: the above shall be separately sub-classified as –
(a) Secured, considered Good
(b) Unsecured, considered Good
(c) Doubtful.

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

4. **Directors, etc**.: loans and advances due by Directors or Other Officers of the Company or any of
them either severally or jointly with any other persons or amounts due by Firms or Private Companies respectively in which any director is a Partner in a director of a Member should be separately stated.

(1) (E) OTHER NON-CURRENT ASSETS

1. General classification - Other Non-Current Assets shall be classified as
(a) long-term trade receivables (including trade receivables on deferred Credit terms)
(b) Others (specify nature)

- Dues in respect of Insurance Claims, Sale of Fixed assets, Contractually reimbursable expenses, interest accrued on trade receivables, etc., should be classified as "Others" and each such item should be disclosed according to their nature.

2. Security wise Classification:
3. Bad / Doubtful:
4. Directors, etc.:

Same as above.

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(2) CURRENT ASSETS

(2) (A) CURRENT INVESTMENTS

Current Investments shall be classified as –
(a) investments in equity instruments,
(b) investment in Preference Shares,
(c) investments in Government or trust Securities,
(d) investments in debentures or Bonds,
(e) investments in Mutual Funds,
(f) investments in Partnership Firms,
(g) Other investments (specify nature)

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

(2) (B) INVENTORIES

Inventories shall be classified as –
(a) Raw materials,
(b) Work In Progress,
(c) Finished Goods,
(d) Stock-in-Trade (in respect of goods acquired for trading),
(e) Stores and Spares,
(f) Loose tools,
(g) Others (specify nature)

- Goods in Transit should be included under relevant heads with suitable disclosure.
- The heading "Finished Goods" should comprise all Finished Goods other than those acquired for trading purposes.
- Those acquired for trading purposes are to be shown under "Stock in Trade".

(2) (C) TRADE RECEIVABLES

Ageing to be provided

Particulars	Outstanding for a period					
	< 6 months	6m – 1 year	1 – 2 years	2-3 Years	> 3 Years	Total
Undisputed – Good						
Undisputed – Doubtful						
Disputed – Good						

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Disputed - Doubtful						

2. Security wise Details: trade receivables shall be separately sub classified as –
(a) Secured, considered Good
(b) Unsecured, considered Good
(c) Doubtful.

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

4. Directors, etc: debts due by directors or Other Officers of the Company or any of them either severally or jointly with any other person or debts due by Firms or Private Companies, respectively in which any director is a Partner, or a director, or a Member should be separately stated.

- Where no due date is specifically agreed upon, normal credit period allowed by the Company should be taken into consideration for computing the due date, which may vary depending upon the Nature of Goods or Services sold and the type of Customers, etc.
- Lean Period Activities: Receivables arising out of sale of materials / rendering of services during a Company's lean period, should be included under "Trade Receivables", if such activity is in the normal course of business. If they are not part of "normal course of business", they are to be classified under "Other Assets".

(2) (D) CASH AND CASH EQUIVALENTS

Cash and Cash Equivalents shall be classified as –
(a) Balances with Banks,
(b) Cheques, drafts on Hand,
(c) Cash on Hand,
(d) Other (Specify nature).

- Earmarked Balances with Banks (e.g. for Unpaid dividend) shall be separately stated.
- Balances with Banks to the extent held as margin Money or Security against the Borrowings, Guarantees, Other Commitments shall be disclosed separately.
- Repatriation restrictions, if any, in respect of Cash and Bank Balances shall be separately stated.
- Bank Deposits with more than 12 months Maturity shall be disclosed separately.

(2) (E) SHORT TERM LOANS AND ADVANCES

1. General Classification: Short-Term Loans and Advances shall be classified as –
(a) loans and advances to related Parties (giving details thereof),
(b) Others (specify nature).

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

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

PART II

Name o

Profit and loss Statement for the year ended:..... (rs. in .....)

Sr.No.	Particulars	Note No.	Figures for the Current reporting Period	Figures for the Previous reporting period
I	Revenue from Operations			
II	Other income			
III	Total Income (I+II)			
IV	Expenses			
	Cost of Materials Consumed Purchases of Stock-In-Trade Changes in inventories of Finished Goods /			

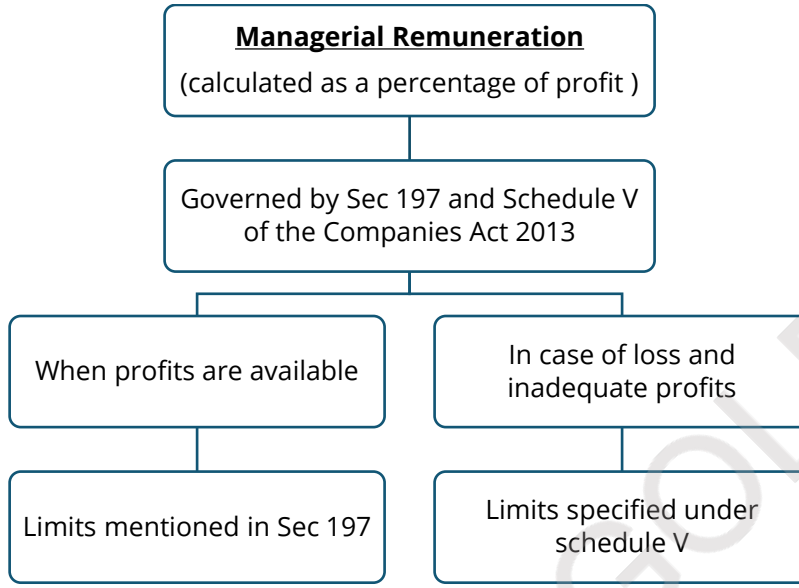
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	Work-in-progress and Stock-In-Trade Employee Benefits Expense Finance Costs Depreciation and amortization expense Other expenses			
	Total expenses			
V	Profit before Exceptional & Extraordinary items and tax (III – IV)			
VI	Exceptional items			
VII	Profit before Extraordinary Items and Tax (V-VI)			
VIII	Extraordinary items			
IX	Profit before Tax (VII-VIII)			
X	Tax expenses: (1) Current tax (2) deferred tax			
XI	Profit /(Loss) for the period from Continuing Operations (IX – X)			
XII	Profit /(Loss) from Discontinuing Operations			
XIII	Tax expense of discontinuing Operations			
XIV	Profit /(Loss) from Discontinuing Operations (after tax) (XII-XIII)			
XV	Profit / (Loss) for the period (XI + XIV)			
XVI	earnings per equity Share: (1) Basic (2) Diluted			

MANAGERIAL REMUNERATION

Remuneration is defined under section 2(78) of the Companies Act, 2013, which states that "Remuneration" means any money or its equivalent given or passed to any person for services rendered by him and includes perquisites as defined under the Income-tax Act, 1961.
Remuneration paid by the company to its Key Managerial Personnel (KMPs) and other directors is Managerial Remuneration. Section 197 of the Companies Act gives overall maximum managerial remuneration in various scenarios.

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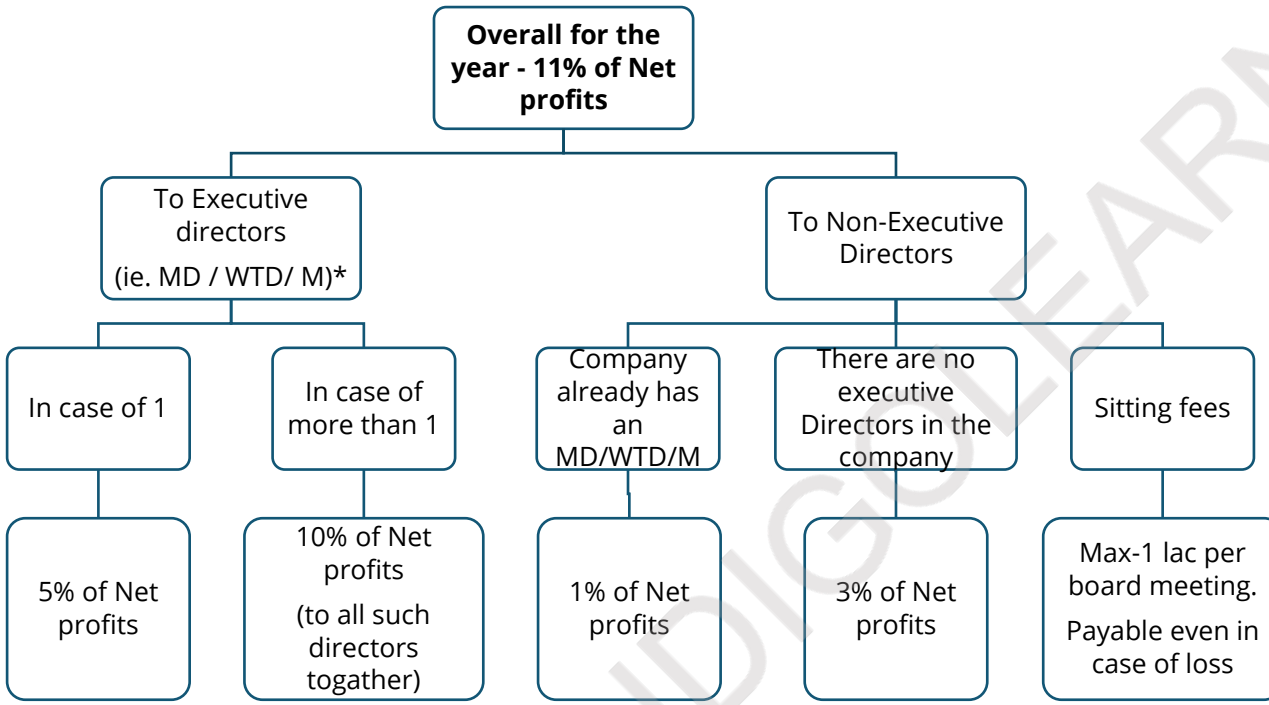


SECTION 197

- Prescribes the overall maximum managerial remuneration payable and also managerial remuneration in case of absence or inadequacy of profits.
- Total managerial remuneration payable
  - by a public company,
  - to its directors, including managing director and whole-time director, and its manager
  - in respect of any financial year
  - should not exceed **11%** of the net profits of that company,
  - computed in the manner laid down in section 198
  - except that the remuneration of the directors should not be deducted from the gross profits.
- The company in general meeting may, authorise the payment of remuneration exceeding 11% of the net profits of the company, subject to the provisions of Schedule V.

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

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

Net profits is computed as specified in Sec 198

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

1. THE FOLLOWING CREDIT SHOULD BE ADDED TO GROSS PROFIT

a) Subsidies or bounties received from any Government, or any public authority, unless the Central Government otherwise directs

2. THE FOLLOWING CREDITS SHOULD NOT BE ADDED TO GROSS PROFIT

a) Profits, by way of premium on shares or debentures, which are issued or sold by the company
b) Profits on sales by the company of forfeited shares
c) Profits of a capital nature including profits from the sale of the undertaking or any of the undertakings of the company or of any part thereof
d) Profits from the sale of any immovable property or fixed assets of a capital nature

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

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

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

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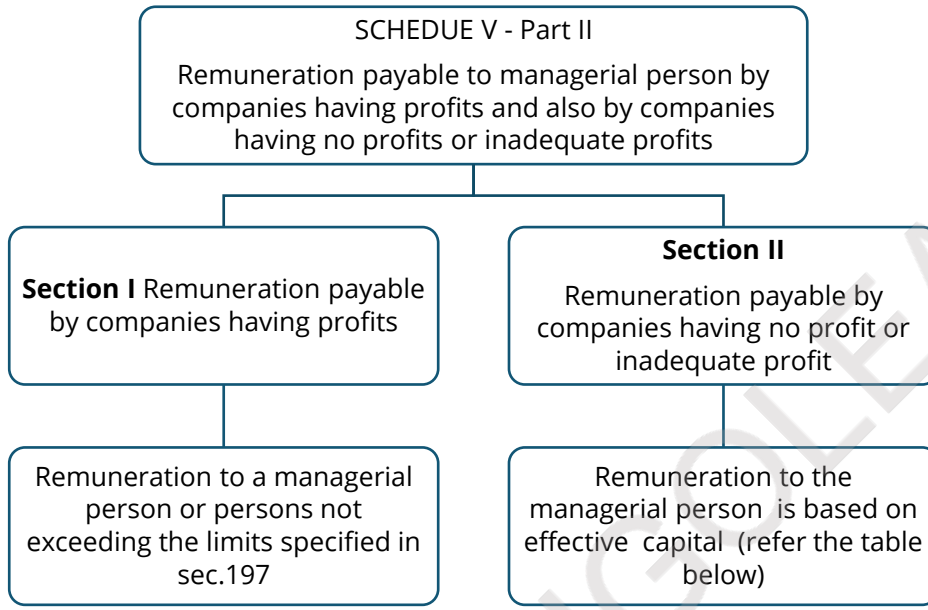
3. THE FOLLOWING DEBITS SHOULD BE DEDUCTED FROM GROSS PROFIT

a) all the usual working charges
b) directors' remuneration
c) bonus or commission paid or payable
d) any tax notified by the Central Government as being in the nature of a tax on excess or abnormal profits
e) any tax on business profits imposed for special reasons or in special circumstances and notified by the Central Government in this behalf
f) interest on debentures
g) interest on mortgages and loans and advances
h) interest on unsecured loans and advances
i) expenses on repairs, provided the repairs are not of a capital nature
j) outgoings inclusive of contributions made under section 181 of the Act
k) depreciation to the extent specified in section 123 of the Act
l) the excess of expenditure over income, which had arisen in computing the net profits in accordance with this section in any year which begins at or after the commencement of this Act, in so far as such excess has not been deducted in any subsequent year preceding the year in respect of which the net profits have to be ascertained
m) any compensation or damages to be paid in virtue of any legal liability including a liability arising from a breach of contract
n) any sum paid by way of insurance against the risk of meeting any liability such as is referred to in clause (m)
o) bad debts written off

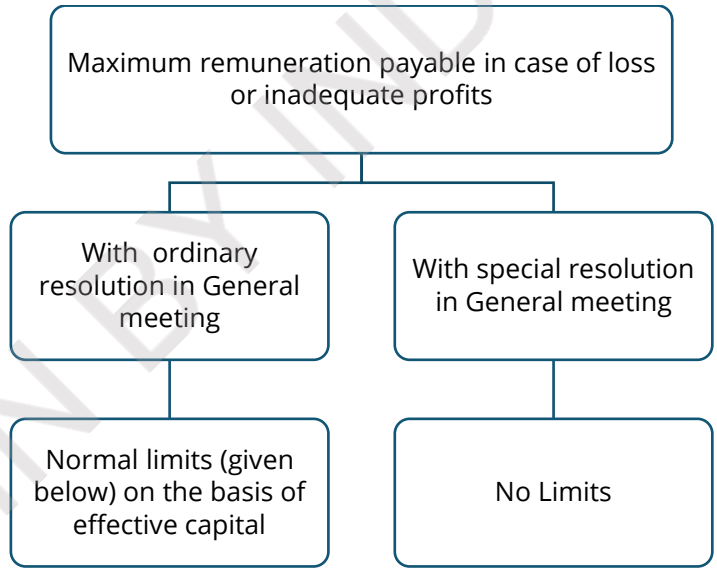
4. THE FOLLOWING DEBITS SHOULD NOT BE DEDUCTED FROM GROSS PROFIT

a) Income-tax and super-tax payable under the Income-tax Act, 1961.
b) Any compensation, damages or payments made voluntarily, (other than those mentioned above)
c) loss of a capital nature not including any excess of the written-down value of any asset which is sold, discarded, demolished or destroyed over its sale proceeds or its scrap value
d) any change in carrying amount of an asset or of a liability recognised in equity reserves including surplus in profit and loss account on measurement of the asset or the liability at fair value

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



NORMAL LIMIT BASED ON EFFECTIVE CAPITAL

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

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

Note –

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

CONDITIONS SUBJECT TO WHICH THE LIMITS APPLY

- Payment of remuneration is approved by a Board resolution passed and, in the case of a company covered under Section 178(1) also by the Nomination and Remuneration Committee.
- The company has not committed any default in repayment of any of its debts (including public deposits) or debentures or interest payable thereon for a continuous period of 30 days in the preceding financial year before the date of appointment of such managerial person and

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- In case of a default, the company obtains prior approval from secured creditors for the proposed remuneration and the fact of such prior approval having been obtained is mentioned in the explanatory statement to the notice convening the general meeting
- An ordinary resolution or a special resolution, as the case may be, has been passed at the general meeting of the company for a period not exceeding 3 years.
- A statement along with a notice calling the general meeting referred to in the above clause is given to the shareholders containing the following information, namely:-

I. General Information:

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

II. Information about the appointee:

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

III. Other information:

(1) Reasons of loss or inadequate profits
(2) Steps taken or proposed to be taken for improvement
(3) Expected increase in productivity and profits in measurable terms.

IV. Disclosures:

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

(1) all elements of remuneration package such as salary, benefits, bonuses, stock options, pension, etc., of all the directors;
(2) details of fixed component and performance linked incentives along with the performance criteria;
(3) service contracts, notice period, severance fees;
(4) stock option details, if any, and whether the same has been issued at a discount as well as the period over which accrued and over which exercisable.

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PERQUISITES NOT INCLUDED IN MANAGERIAL REMUNERATION

1. A managerial person should be eligible for the following perquisites which should not be included in the computation of the ceiling on remuneration specified in Section II and Section III:-
   - **(a)** contribution to provident fund, superannuation fund or annuity fund to the extent these either singly or put together are not taxable under the Income- tax Act, 1961;
   - **(b)** gratuity payable at a rate not exceeding half a month's salary for each completed year of service; and
   - **(c)** encashment of leave at the end of the tenure.
2. In addition to the perquisites specified in paragraph 1 of this section, an expatriate managerial person (including a non-resident Indian) should be eligible to the following perquisites which should not be included in the computation of the ceiling on remuneration specified in Section II or Section III-
   - **(a)** Children's education allowance: In case of children studying in or outside India, an allowance limited to a maximum of Rs. 12,000 per month per child or actual expenses incurred, whichever is less. Such allowance is admissible up to a maximum of two children.
   - **(b)** Holiday passage for children studying outside India or family* staying abroad: Return holiday passage once in a year by economy class or once in two years by first class to children and to the members 'of the family* from the place oftheir study or stay abroad to India if they are not residing in India, with the managerial person.
   - **(c)** Leave travel concession: Return passage for self and family in accordance with the rules specified by the company where it is proposed that the leave be spent in home country instead of anywhere in India.

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

DIVISIBLE PROFIT

- A dividend is a distribution of divisible profit of a company among the members according to the number of shares held by each of them in the capital of the company and the rights attaching thereto.
- Such a distribution may or may not entail a release of assets; it would be where a distribution involves payment of cash.d
- Bonus shares cannot be issued in lieu of dividends.
- Capital cannot be returned to the shareholders by way of dividend.
- A company who has committed any default in compliance with the provisions of sec- 73 and 74 relating to the acceptance and repayment of deposits would be barred to declare dividend.
- Dividend should be declared or paid only from free reserves.
- Dividend shall be payable by way of

  (i) cash (ii) cheque (iii) warrant or (iv) in any electronic mode
- It shall be payable to the registered shareholder of such share or to his order or to his banker

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- A company **may,** before the declaration of any dividend in any financial year, transfer such percentage of its profits for that financial year, as it may consider appropriate to the reserves of the company.

Appropriation of a part of profit can be done in the following cases
1. When required under a law - For example, under the Banking Regulation Act
2. When required under any contract – For example where the company has undertaken, at the time of raising of loan, that before any part of its profit is distributed, a specified percentage of the profit every year should be credited to a reserve for the repayment of the loan and until the time for repayment arrives, the amount should remain invested in a specified manner

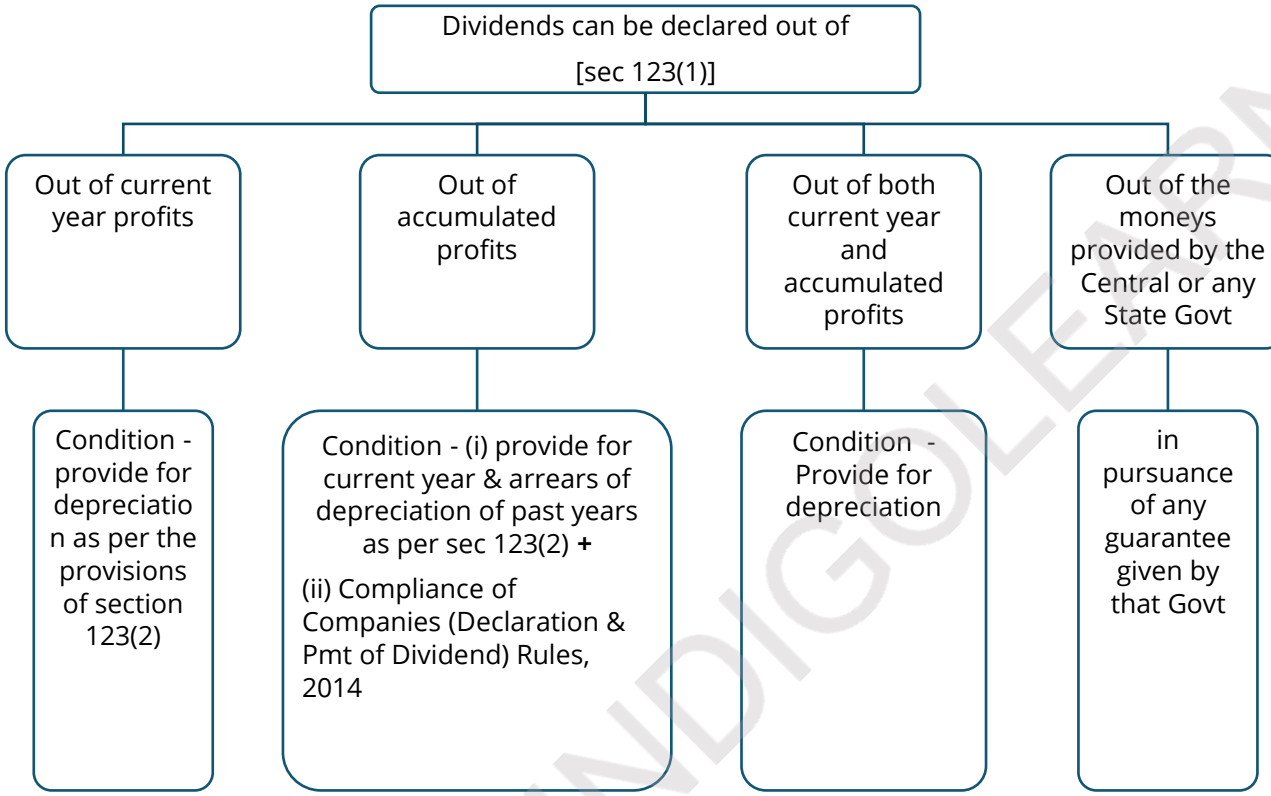
- A company may if so authorised by its Article, pay a dividend in proportion to the amount paid on each share in case of partly paid shares.
- Calls paid in advance do not rank for payment of dividend.
- Dividend on preference shares
    - Holders of preference shares are entitled to receive a dividend at a fixed rate before any dividend is declared on equity shares.
    - But such a right can be exercised subject to there being profits and the Directors recommending payment of the dividend.

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

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

★ **Sec 123 (3)** - In case the company has incurred loss during the current financial year up to the end of the quarter immediately preceding the date of declaration of interim dividend, such interim dividend should not be declared at a rate higher than the average dividends declared by the company during the immediately preceding three financial years.

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

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

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

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

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

(3) The **amount so drawn should first be utilised** to set off the losses incurred in the financial year in which dividend is declared before any dividend in respect of equity shares is declared.

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

(5) No company should declare dividend unless **carried over previous losses** and depreciation not provided in previous year, are set off against profit of the company of the current year.

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The loss or depreciation, whichever is less, in previous years is set off against the profit of the company for the year for which dividend is declared or paid.

Sec 124 - Payment of dividend

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

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

(3) **Transfer to unpaid dividend account** - Where any dividend has not been paid or claimed within thirty days from the date of the declaration to any shareholder the company should, **within 7 days** from the date of expiry of the said period of 30 days, transfer the total amount of dividend which remains unpaid or unclaimed to a special account to be opened by the company in that behalf in any scheduled bank to be called the Unpaid Dividend Account.

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

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

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

(7) **Transfer to Investor education and protection fund** - Any money transferred to the Unpaid Dividend Account of a company which remains **unpaid or unclaimed for a period of 7 years** from the date of such transfer should be transferred by the company along with interest accrued, if any, thereon to the Fund "Investor Education and Protection Fund" established section 125.

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

(9) **Transfer of Share -** All shares in respect of which unpaid or unclaimed dividend has been transferred to "Investor Education and Protection Fund" should also be transferred by the company in the name of Investor Education and Protection Fund along with a statement containing such details as may be prescribed:

Provided that any claimant of shares transferred above should be entitled to claim the transfer of shares from Investor Education and Protection Fund in accordance with such procedure and on submission of such documents as may be prescribed.

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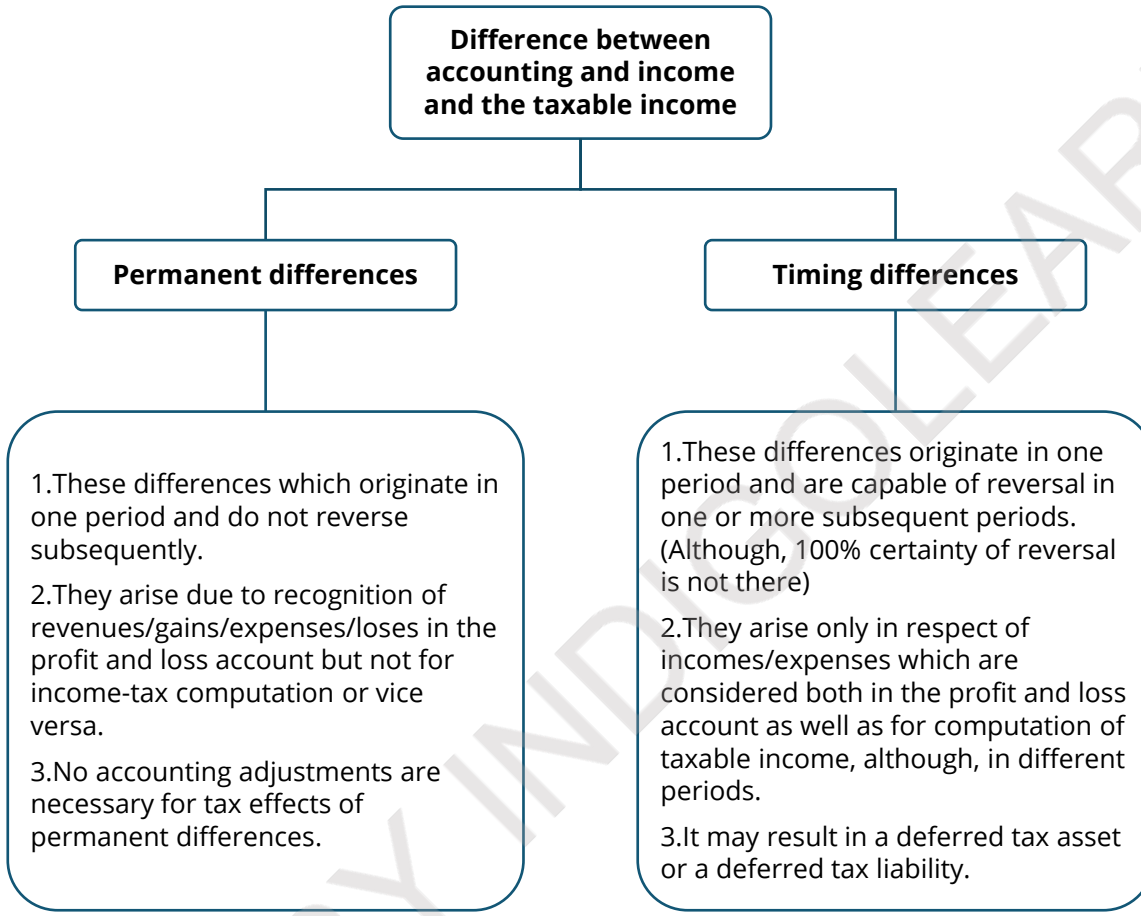
(10) **Punishment for failure to distribute dividend** - If a company fails to comply with any of the requirements of this section,

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

ACCOUNTING FOR TAXES

- AS 22 Accounting for Taxes on Income prescribes the accounting treatment of taxes on income and follows the concept of matching expenses against revenue for the period.
- The concept of matching is more peculiar in cases of income taxes since in a number of cases, the taxable income may be significantly different from the income reported in the financial statements due to the difference in treatment of certain items under taxation laws and the way it is reflected in accounts.
- Accounting for taxes on income should be in accordance with AS 22, irrespective of whether such taxes are imposed by an Indian law or by the law of a foreign country.
- The amount to be included in respect of income-tax in the profit and loss account should be the current tax plus or minus the deferred tax. Current tax is the tax determined in accordance with the provisions of the Income- tax Act, 1961. Deferred tax is the tax effect of timing differences.

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

DTA or DTL is created in the following cases

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

DTA is recognized in a case where there are unabsorbed losses/deprecation under the tax laws. DTA should be recognized only to the extent there is virtual certainty supported by convincing evidence that adequate future taxable income will be available against which DTAs can be realised. Mere forecasts of performance would not satisfy this criterion. virtual certainty has to be backed up by convincing evidence i.e. evidence available at the reporting date in concrete form.

Journal entries
In the year in which timing difference originates – In case of DTA

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DTA A/c Dr.

To Profit & loss A/c

Note : The amount to be debited and credited arrived at by multiplying the timing difference with the tax rate applicable for the year

In case of DTL

Profit and Loss A/c Dr.

To Deferred tax Liability A/c

In the subsequent year - This is the entry to be passed to account for the difference between the opening and closing balance in the DTA a/c which represents reversal of timing difference during the year

Profit and loss A/c Dr.

To DTA A/c

Note:

1. The carrying amount of DTAs has to be reviewed at each balance sheet date.
2. The carrying amount of a DTA has to be written down to the extent that it is no longer reasonably certain or virtually certain, as the case may be, that adequate future taxable income would be available to realize the DTA.
3. Reversal of a previous write-down may be done to the extent it becomes reasonably certain or virtually certain, as the case may be, that adequate future taxable income would be available.
4. If the recognition criteria is not met, the entire balance should be written off.

Illustrations

Illustration 1

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

(Figures in Rs.'000)

Particulars	Debit Rs.	Particulars	Credit Rs.
Land at cost	220	Equity Capital (Shares of Rs. 10 each)	300
Plant & Machinery at cost	770	10% Debentures	200
Trade Receivables	96	General Reserve	130
Inventories (31.3.X2)	86	Profit & Loss A/c	72
Bank	20	Securities Premium	40
Adjusted Purchases	320	Sales	700
Factory Expenses	60	Trade Payables	52

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Administration Expenses	30	Provision for Depreciation	172
Selling Expenses	30	Suspense Account	4
Debenture Interest	20		
Interim Dividend Paid	18		
	1670		**1670**

Additional Information:

i. The authorised share capital of the company is 40,000 shares of Rs. 10 each.

ii. The company on the advice of independent valuer wish to revalue the land at Rs. 3,60,000.

iii. Declared final dividend @ 10%.

iv. Suspense account of Rs. 4,000 represents cash received for the sale of some of the machinery on 1.4.20X1. The cost of the machinery was Rs. 10,000 and the accumulated depreciation thereon being Rs. 8,000.

v. Depreciation is to be provided on plant and machinery at 10% on cost.

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

Solution: Illustration 1

Balance Sheet as at 31st March, 20X2

Particulars			**Note No.**	**(₹ in 000)**
Equity and Liabilities				
1.	**Shareholders' funds**			
	A	Share capital	1	300
	B	Reserves and Surplus	2	500
2.	**Non-Current liabilities**			
	A	Long term borrowings	3	200
3.	**Current liabilities**			
	A	Trade Payables		52
	B	Other Current Liabilities	4	30
		Total		**1082**
Assets				
1.	**Non-current assets**			
	A	PPE (Property, Plant & Equipment)	5	880
2.	**Current assets**			
	A	Inventories		86
	B	Trade receivables		96
	C	Cash and bank balances	6	20

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		Total		**1082**

Statement of Profit and Loss for the year ended 31st March, 20X2

	Particulars	**Notes**	**(₹ in 000)**
I.	Revenue from operations		700
II	Other Income (WN)	7	2
III	**Total Revenue (I + II)**		**702**
IV	Expenses:		
	Purchases of stock – in – Trade* (WN)		320
	Changes in inventories		(86)
	Finance Cost	8	20
	Depreciation on Plant and Machinery	9	76
	Other Expenses	10	120
	Total Expenses		**536**
V.	**Profit (Loss) for the period (III – IV)**		**166**

Notes to accounts

				(₹ in 000)
1.	**Share Capital**			
	Equity share capital			
	Authorised:			
	40,000 shares of ₹10 each			400
	Issued & subscribed & called up			
	30,000 shares of ₹10 each			300
2.	**Reserves and Surplus**			
	Securities Premium Account			40
	General reserve			130
	Revaluation reserve	(360 – 220)		140
	Profit & loss (Surplus)			
	Opening balance	72		
	Add: Profit for the period	166	238	
	Less: Interim Dividend		(18)	
	Final Dividend		(30)	190
				500
3.	**Long term borrowing**			
	10% Debentures			200
4.	**Other Current Liabilities**			
	Dividend Payable			30

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5.	**PPE (Tangible Assets)**		
	Land		
	Opening balance	220	
	Add: Upward Revaluation	140	
	Closing balance		360
	Plant and Machinery		
	Cost (Working Note)	760	
	Less: Accumulated Depreciation	(240)	520
	Total		880
6.	**Cash and Cash Equivalence**		
	Balance with Bank		20
7.	**Other Income**		
	Gain on Sale of Plant & Machinery (WN)		2
8.	**Finance Cost**		
	Debenture Interest		20
9.	**Depreciation on Plant and Machinery**		76
10.	**Other Expenses**		
	Factory expenses	60	
	Selling expenses	30	
	Administrative expenses	30	120

Note: It is Assumed that Final Dividend is declared prior to 31st March.
If it is assumed that Dividend is declared is declared after the Financial year, then Final Dividend is not required to be provided for.

Working Note:

1)

Plant and Machinery Account (At Cost)

Particulars	**(₹ in 000)**	**Particulars**	**(₹ in 000)**
To Balance b/d	770	By Asset Disposal A/c	10
		By Balance C/d	760
	770		**770**

Accumulated Depreciation A/c

Particulars	**(₹ in 000)**	**Particulars**	**(₹ in 000)**
To Asset Disposal A/c	8	By Balance b/d	172
To Balance C/d	240	By Depreciation	76
	248		**248**

Asset Disposal A/c

Particulars	**(₹ in 000)**	**Particulars**	**(₹ in 000)**

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To Plant and Machinery	10	By Accumulated Depreciation	8
To Gain on Sale of P&M	2	By Suspense	4
	12		**12**

2)

Adjusted Purchases	320
Closing Stock*	86
Purchases (Gross)	406

Assumed there is no stock at beginning

Illustration – 2

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

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

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Stock on hand, 1st April, 2011:		
Wines, Cigarettes, Cigars etc.	12,800	
Foodstuffs	5,260	
Cash in hand	2,200	
Cash with Bankers	76,380	
Preliminary and formation expenses	8,000	
2,000 Debentures of Rs.100 each (6%)		2,00,000
Profit and Loss Account		41,500
Sundry Creditors		42,000
Sundry Debtors	19,260	
Investments	2,72,300	
Goodwill at cost	5,00,000	
General Reserve		2,00,000
	19,75,000	**19,75,000**
Wages and Salaries Outstanding	1,280	
Stock on 31st March, 2012:		
Wines Cigarettes and Cigars, etc.	22,500	
Foodstuffs	16,400	

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

Solution: Illustration 2

Balance Sheet of International Hotels Ltd. as at 31st March, 20X2

Particulars			**Note No.**	**₹**
Equity and Liabilities				
1.	**Shareholders' funds**			
	i	Share capital	1	13,00,000
	ii	Reserves and Surplus	2	1,74,745
2.	**Non-Current liabilities**			

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	i	Long term borrowings	3	2,00,000
3.	**Other Current liabilities**			
	i	Trade Payables		42,000
	ii	Other Current Liabilities	4	1,07280
		Total		**18,24,025**
Assets				
1.	**Non-current assets**			
	i	PPE (Property, Plant & Equipment)	5	9,14,985
	ii	Intangible Assets	6	5,00,000
	iii	Non-current investments		2,72,300
2.	**Current assets**			
	i	Inventories	7	38,900
	ii	Trade receivables		19,260
	iii	Cash and Cash Equivalents	8	78,580
		Total		**18,24,025**

	Particulars	**Notes**	**Amount**
I.	Revenue from operations	9	1,83,200
II.	Other income (Discount received)	10	3,300
III.	**Total Revenue (I + II)**		**1,86,500**
IV.	**Expenses:**		
	Cost of materials consumed	11	25,060
	Purchases of Stock-in-Trade	12	45,800
	Changes in inventories	13	(9,700)
	Employee benefits expense	14	29,580
	Finance costs	15	12,000
	Depreciation and Amortization expense	5	21,315
	Other Expenses	16	40,200
	Total Expenses		**1,64,255**
V.	**Profit Before Tax (III - IV)**		**22,245**

Statement of Profit and Loss of International Hotels Ltd. for the year ended 31st March, 20X2

Notes to accounts

				(₹)
1.	**Share Capital**			
	Share capital			
	Authorised:			
	5,000 6% preference of ₹100			5,00,000
	10,000 shares of ₹100 each			10,00,000
				15,00,000

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	Issued, subscribed & fully paid up			
	5,000 6% preference of ₹100			5,00,000
	8,000 shares of ₹100 each			8,00,000
				13,00,000
2.	**Reserves and Surplus**			
	Capital Reserve (100 x (90 – 40))			5,000
	Securities Premium Account			
	General reserve			
	Opening Balance		2,00,000	
	Less: Transferred to P&L		(30,255)	1,69,745
	Profit & loss (Surplus)			
	Opening balance	41,500		
	Add: Profit for the period	22,245		
	Add: Balance from General Reserve	30,255	94,000	
	Less: Dividend declared		(94,000)	--
	Total			1,74,745
3.	**Long term borrowing**			
	6% Debentures			2,00,000
4.	**Other Current Liabilities**			
	Dividend Payable		1,280	
	Interest Payable		12,000	
	Dividend Payable		94,000	1,07280
	Total			
6.	**Intangible Assets**			
	Goodwill			5,00,000
7.	**Inventories**			
	Wines, Cigarettes & Cigars, etc (Finished Goods)		22,500	
	Foodstuffs (Raw Material)		16,400	
	Total			**38,900**
8.	**Cash and Cash Equivalents**			
	Cash in hand		2,200	
	Cash at bank		76,380	
	Total			**78,580**
9.	**Revenue from operations**			
	Sale of products			
	- Wines, Cigarettes, Cigars etc.		68,400	
	- Food		57,600	1,26,000
	Sale of services			
	- Room Rent		48,000	

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	- Billiards	5,700	
	- Transfer fees	700	
	- Miscellaneous Receipts	2,800	57,200
	Total		**1,83,200**
10.	**Other Income**		
	- Discount		3,300
11.	**Cost of Material Consumed**		
	Opening Inventory	5,260	
	Add: Purchases during the year	36,200	
	Less: Closing Inventory	(16,400)	
	Total		**25,060**
12.	**Purchases of Inventory-in-Trade**		
	Wines, Cigarettes etc.		45,800
13.	**Changes in inventories of finished goods work-in-progress and Inventory-in-Trade**		
	Opening Inventory	12,800	
	Less: Closing Inventory	(22,500)	(9,700)
14.	**Employee benefits expense**		
	Wages and Salaries	28,300	
	Add: Wages and Salaries Outstanding	1,280	29,580
15.	**Finance costs**		
	Interest on Debentures (2,00,000 x 6%)		12,000
16.	**Other Expenses:**		
	- Rent Rates and Taxes	8,900	
	- Laundry	750	
	- Coal and Firewood	3,290	
	- Carriage and Cooliage	810	
	- Sundry Expenses	5,840	
	- Advertising	8,360	
	- Repairs	4,250	
	- Preliminary Expenses	8,000	40,200

Note – 5: PPE (Property, Plant & Equipment)

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	Assets	01/04/X1	Depreciation	31/03/X2
1.	Land and Building (2% of 8,50,000)	8,50,000	17,000	8,33,000
2.	Furniture and Fixtures. (5% of 86,300)	86,300	4,315	81,985
			21,315	**9,14,985**
			P&L	**B/S**

Working Note:

1) Equity Share Capital

Opening Paid up 6,000 @ ₹100 2,000 @ ₹60	₹6,00,000 ₹1,20,000
Called up (20 × 2) 2,000 @ 40 Amount Received 1,900 @ 40	 ₹76,000
	₹7,96,000
Reissue of forfeited Shares @₹90 (100 × 90)	₹9,000
	₹8,05,000

2) Dividend Payable

- Pref shares 6% of 50 Lakh = ₹30,000
- Equity Shares 8% of 8 Lakh = ₹64,000

			(₹)
1.	**Share Capital**		
	Share capital		
	Authorised, subscribed & Called up		
	10,000 shares of ₹100 each (Out of above,2,000 shares have been issued for consideration other than cash)	10,00,000	
	Less: Calls in arrears	(1,000)	9,99,000
2.	**Reserves and Surplus**		
	General Reserve	2,10,000	
	Profit & loss (Surplus)	86,700	2,96,700
3.	**Long term borrowing**		
	Secured		2,00,000
	Term Loans		
	Loan from State Financial Corporation (1,50,000 – 7,500) (Secured by hypothecation of Plant and Machinery)		1,42,500
4.	**Other Current Liabilities**		
	Interest Accrued (not due)	7,500	
	Dividend Payable	60,000	67,500

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5.	**Short-term provisions**		
	Provision for taxation		68,000
	Goodwill		5,00,000
7.	**Inventories**		
	Raw Material	50,000	
	Finished Goods	2,00,000	2,50,000
8.	**Trade receivables**		
	Amount Receivable more than 6 months	52,000	
	Others (Bal. fig)	1,48,000	2,00,000
9.	**Cash and cash Equivalents**		
	Cash at Bank	2,47,000	
	Cash in hand	30,000	2,77,000
	- Rent Rates and Taxes	8,900	
	- Laundry	750	
	- Coal and Firewood	3,290	
	- Carriage and Cooliage	810	
	- Sundry Expenses	5,840	
	- Advertising	8,360	
	- Repairs	4,250	
	- Preliminary Expenses	8,000	40,200

=₹94,000
Amount Available in P&L (₹63,745)
Shortfall = ₹30,255

Illustration – 3

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

		Assets (Rs.)	**Liabilities (Rs.)**
Equity Capital (Face value of Rs.100) Calls in Arrears		 1,000	10,00,000
Land		2,00,000	
Building		3,50,000	

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Plant and Machinery		5,25,000	
Furniture		50,000	
General Reserve			2,10,000
Loan from State Financial Corporation			1,50,000
Inventory:			
Finished Goods	2,00,000		
Raw Materials	50,000	2,50,000	
Provision for Taxation			68,000
Trade receivables		2,00,000	
Advances		42,700	
Dividend Payable			60,000
Profit and Loss Account			86,700
Cash Balance		30,000	
Cash at Bank		2,47,000	
Loans (Unsecured)			1,21,000
Trade payables (For Goods and Expenses)			2,00,000
		18,95,700	18,95,700

The following additional information is also provided:

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

  Building Rs.4,00,000
  Plant and Machinery Rs.7,00,000
  Furniture Rs.62,500
- The balance of Rs.1,50,000 in the loan account with State Finance Corporation is inclusive of Rs.7,500 for interest accrued but not due. The loan is secured by hypothecation of the Plant and Machinery.
- Balance at Bank includes Rs.2,000 with Perfect Bank Ltd., which is not a Scheduled Bank.
- The company had contract for the erection of machinery at Rs.1,50,000 which is still incomplete.
- **Solution**: Illustration 3
- **Pioneer Ltd. - Balance Sheet as at 31st March, 20X1**

Particulars	**Note No.**	**₹**

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Equity and Liabilities				
1.	**Shareholders' funds**			
	i	Share capital	1	9,99,000
	ii	Reserves and Surplus	2	2,96,700
2.	**Non-Current liabilities**			
	i	Long term borrowings	3	2,63,500
3.	**Other Current liabilities**			
	i	Trade Payables		2,00,000
	ii	Other Current Liabilities	4	1,07280
	iii	Short-term provisions	5	68,000
		Total		**18,94,700**
Assets				
1.	**Non-current assets**			
	i	PPE (Property, Plant & Equipment)	6	11,25,000
2.	**Current assets**			
	i	Inventories	7	2,50,000
	ii	Trade receivables	8	2,00,000
	iii	Cash and Cash Equivalents	9	2,77,000
	iv.	Short-term Loans And advances		42,700
		Total		**18,94,700**

- **Notes to accounts**
- **Note – 6: PPE (Property, Plant & Equipment)**

	Assets	Cost	Accumulated Depreciation	WDV
1.	Building	4,00,000	50,000	3,50,000
2.	Plant and Machinery	7,00,000	1,75,000	5,25,000
3.	Furniture	62,500	12,500	50,000
4.	Land	2,00,000	--	2,00,000
		13,62,500	2,37,500	**11,25,000**

- **Note:** Estimated amount of contract remaining to be executed on capital account and not provided for ₹1,50,000. It has been assumed that the company had given this contract for purchase of machinery.

Illustration – 4

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

(Rs.)

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

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

Solution: Illustration 4

Condition I. Maximum Rate = 12% (Avg. of 3years)

Dividend Payable	
Preference shares = 17,50,000 × 9%	1,57,500
Equity Shares = 80,00,000 × 10%	8,00,000
Total Dividend	9,57,500
Surplus in P/L	3,00,000
Amount to be Withdrawn	6,57,500

Condition II.

Maximum amount that can be drawn from the accumulated profits and reserves should not exceed **10% of paid up capital plus free reserves** ie. ₹12,25,000 [10% of (80,00,000+17,50,000+25,00,000)]

Condition III

The balance of reserves after withdrawal

18,42,500 (₹25,00,000 - ₹6,57,500) should not fall below 15 % of its paid up capital ie. ₹14,62,500 (15% of ₹97,50,000]

Since all the three conditions are satisfied, the company can withdraw **₹6,57,500** from accumulated reserves (as per Declaration and Payment of Dividend Rules, 2014.)

Illustration 5

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

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

Liabilities	Rs.
Authorised capital: 20,000, 14% preference shares of Rs.100	20,00,000
2,00,000 Equity shares of Rs.100 each	2,00,00,000
Issued and subscribed capital:	2,20,00,000
15,000, 14% preference shares of Rs.100 each fully paid	15,00,000
1,20,000 Equity shares of Rs.100 each, Rs.80 paid-up	96,00,000
Share suspense account	20,00,000

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Reserves and surplus: Capital reserves (Rs. 1,50,000 is revaluation reserve)	1,95,000
Securities premium	50,000
Secured loans: 15% Debentures	65,00,000
Unsecured loans: Public deposits	3,70,000
Cash credit loan from SBI (short term)	4,65,000
Current Liabilities: Trade Payables	3,45,000
Assets:	**Rs.**
Investment in shares, debentures, etc.	75,00,000
Profit and Loss account (Debit balance)	15,25,000

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

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

Solution: Illustration 5

	Where X Ltd. Is a noninvestment company	**Where X Ltd. is an investment company**
Paid-up share capital — 15,000, 14% Preference shares	15,00,000	15,00,00
1,20,000 Equity shares	96,00,000	96,00,000
Capital reserves (1,95,000 – 1,50,000)	45,000	45,000
Securities premium	50,000	50,000
15% Debentures	65,00,00	65,00,00
Public Deposits	3,70,000	3,70,000
	1,80,65,000	1,80,65,000
Less: Profit and Loss account (Dr. balance)	15,25,00	15,25,00
Investments	75,00,000	-
	90,25,000	15,25,000
Effective capital	**90,40,000**	**1,65,40,000**

Illustration – 6

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

	Rs.		**Rs.**

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

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

Solution: Illustration 6

Calculation of net profit u/s 198 of the Companies Act, 2013

Particulars	**₹**
Gross Profit (Balance from Trading A/c)	40,25,365
Add: Subsidies received from Government	2,73,925
	42,99,290
Less: Administrative, selling and distribution expenses	8,22,542
Director's fees	1,34,780
Interest on debentures	31,240
Depreciation on fixed assets as per Schedule II	5,75,345
Profit u/s 198	**27,35,383**

Maximum Managerial remuneration under Companies Act, 2013= 11% of ₹27,35,383= ₹3,00,892

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Illustration 7

Kumar Ltd., a non-investment company has been incurring losses for the past few years. The company provides the following information for the current year:

	(Rs. In lakhs)
Paid up equity share capital	120
Paid up Preference share capital	20
Reserves (including Revaluation reserve Rs.10 lakhs)	150
Securities premium	40
Long term loans	40
Deposits repayable after one year	20
Application money pending allotment	720
Accumulated losses not written off	20
Investments	180

Kumar Ltd. has only one whole-time director, Mr. X. You are required to calculate the amount of maximum remuneration that can be paid to him as per provisions of Part II of Schedule XIII, if no special resolution is passed at the general meeting of the company in respect of payment of remuneration for a period not exceeding three years.

Solution: Illustration 7

Calculation of effective capital

	(₹ in lakhs)
Paid up equity share capital	120
Reserve excluding Revaluation reserve (150- 10)	140
Securities premium	40
Long term loans	40
Deposits repayable after one year	20
Less: Accumulated losses not written off	(20)
Investments	(180)
Effective capital for the purpose of managerial remuneration	**180**

Since Kumar Ltd. is incurring losses and no special resolution has been passed by the company for payment of remuneration, managerial remuneration will be calculated on the basis of **effective capital of the company (< 5 Crores)**, therefore maximum remuneration payable to the Managing Director should be @ ₹60,00,000 per annum.

Illustration 8

Following is the trial balance of Delta limited as on 31.3.2021.

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(Figures in Rs. '000)

Particulars	Debit	Particulars	Credit
Land at cost	800	Equity share capital (shares of Rs. 10 each)	500
Calls in arrears	5	10% Debentures	300
Cash in hand	2	General reserve	150
Plant & Machinery at cost	824	Profit & Loss A/c (balance on 1.4.20)	75
Trade receivables	120	Securities premium	40
Inventories (31-3-21)	96	Sales	1200
Cash at Bank	28	Trade payables	30
Adjusted Purchases	400	Provision for depreciation	150
Factory expenses	80	Suspense Account	10
Administrative expenses	45		
Selling expenses	25		
Debenture Interest	30		
	2455		2455

Additional Information :

(i) The authorized share capital of the company is 80,000 shares of Rs. 10 each.

(ii) The company revalued the land at Rs. 9,60,000.

(iii) Equity share capital includes shares of Rs. 50,000 issued for consideration other than cash.

(iv) Suspense account of Rs. 10,000 represents cash received from the sale of some of the machinery on 1.4.2020. The cost of the machinery was Rs. 24,000 and the accumulated depreciation thereon being Rs. 20,000. The balance of Plant & Machinery given in trial balance is before adjustment of sale of machinery.

(v) Depreciation is to be provided on plant and machinery at 10% on cost.

(vi) Balance at bank includes Rs. 5,000 with ABC Bank Ltd., which is not a Scheduled Bank.

(vii) Make provision for income tax @30%.

(viii) Trade receivables of Rs. 50,000 are due for more than six months.

You are required to prepare Delta Limited's Balance Sheet as at 31.3.2021 and Statement of Profit and Loss with notes to accounts for the year ended 31.3. 2021 as per Schedule Ill. Ignore previous year's figures & taxation.

Solution: Illustration 8

Delta Limited

Balance Sheet as at 31st March 2021

Particulars	Note No.	(₹ in '000)

1FIN BY INDIGOLEARN

Equity and Liabilities				
1.	**Shareholders' funds**			
	i	Share capital	1	495.00
	ii	Reserves and Surplus	2	807.20
2.	**Non-Current liabilities**			
	i	Long term borrowings	3	300.00
3.	**Other Current liabilities**			
	i	Trade Payables		30.00
	ii	Short-term provisions	4	163.80
		Total		**1,796.00**
Assets				
1.	**Non-current assets**			
	i	PPE (Property, Plant & Equipment)	5	1,550.00
2.	**Current assets**			
	i	Inventories		96
	ii	Trade receivables	6	120
	iii	Cash and Cash Equivalents	7	30
		Total		**1,796.00**

Statement of Profit and Loss for the year ended 31st March 2021

	Particulars	**Notes**	**(₹ in '000)**
I.	Revenue from operations	8	1,200
II.	Other income (Discount received)	9	6
III.	**Total Revenue (I + II)**		**1,206**
IV.	**Expenses:**		
	Purchases (Adjusted)		400
	Finance costs	10	30
	Depreciation	5	80
	Other Expenses	11	150
	Total Expenses		**660**
V.	**Profit Before Tax (III - IV)**		**546**
VI.	Tax expenses @30%		163.80
VII.	Profit for the period		**382.20**

Notes to Accounts

			(₹)
1.	**Share Capital**		
	Share capital		
	80,000 Shares of ₹10 each		800
	subscribed & Called up		

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	50,000 shares of ₹10 each (Out of above,5,000 shares have been issued for consideration other than cash)	500	
	Less: Calls in arrears	(5)	495
2.	**Reserves and Surplus**		
	General Reserve		150.00
	Securities Premium		40.00
	Profit & loss (Surplus)		
	Opening Balance	75.00	
	Add: Profit for the period	382.20	457.20
			807.20
3.	**Long term borrowing**		
	10% Debentures		300
4.	**Short – term provision**		
	Provision for tax		163.80
5.	**Property, plant & equipment**		
	Land at cost	800	
	Add: Revaluation	160	960
	Plant and Machinery (at cost)		
	Opening Balance	824	
	Less: Cost of P&M sold	(24)	
	Closing Balance (at cost)	800	
	Less: Depreciation (Accumulated)		
	Opening Balance	150	
	Less: Disposed Off	(20)	
	Add: Current year Depreciation (10% on 800)	80	
		210	1,550.00
6.	**Trade receivables**		
	Debits outstanding for a period exceeding six months	50	
	Other debts	70	120
7.	**Cash and cash Equivalents**		
	- Cash at Bank scheduled banks	23	
	- With others (ABC Bank Limited)	5	
	Cash in hand	2	30
8.	**Revenue from Operations**		
	Sales		1,200
9.	**Other Income**		
	Gain on sale of Fixed asset ₹(10,000 – (24,000 – 20,000)		6

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10.	**Finance Costs**		
	Debenture Interest		30
11.	**Other Expenses**		
	Factory Expenses	80	
	Admin Expenses	45	
	Selling Expenses	25	150

Illustration 9

The following balances appeared in the books of Oliva Ltd. as on 31-03-2022.

Particulars		₹	Particulars		₹
Inventory 01-04-2013			Sales		17,10,000
-Raw Material	30,000		Interest		3,900
-Finished goods	46,500	76,500	Profit and Loss A/c		45,000
Purchases		12,15,000	Share Capital Loans:		3,15,000
Manufacturing Expenses		2,70,000	Short–term	4,500	
Salaries and wages			Long-term	21,000	25,500
General Charges		40,200	Unclaimed Dividend		3,000
		16,500	Deposits:		
Dividend for 2012-13		27,000	Short -Term Long -term	1,500	
Building		1,01,000	Trade payables	3,300	4,800
Plant and					3,27,000
Machinery Furniture		70,400			
Motor Vehicles		10,200			
Stores and Spare Parts		40,800			
Consumed					
Investments: Current		45,000			
Non Current Trade					
receivables Cash in Bank					
	4,500	12,000			
	7,500	2,38,500			
		2,71,100			
		24,34,200			
					24,34,200

From the above balance and the following information, prepare the company's Profit and Loss Account for the year ended 31st March, 2014 and Company's Balance Sheet as on that date:

1. Inventory on 31st March,2014 Raw material ₹ 25,800 & finished goods ₹ 60,000.
2. Outstanding Expenses: Manufacturing Expenses ₹ 67,500 & Salaries & Wages

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₹ 4,500.

3. Interest accrued on Securities ₹ 300.
4. General Charges prepaid ₹ 2,490.
5. Provide depreciation: Building @ 2% p.a., Machinery @ 10% p.a., Furniture @ 10% p.a. & Motor Vehicles @ 20% p.a.
6. Current maturity of long term loan is ₹ 1,000.
7. The Taxation provision of 40% on net profit is considered.

Solution: Illustration 9

Oliva Company Ltd.
Balance Sheet for the year ended 31.03.2019

Particulars			**Note No.**	**₹**
Equity and Liabilities				
1.	**Shareholders' funds**			
	i	Share capital		3,15,000
	ii	Reserves and Surplus	1	50,430
2.	**Non-Current liabilities**			
	i	Long term borrowings	2	23,300
3.	**Current liabilities**			
	i	Short -term borrowings	3	6,000
	ii.	Trade Payables		3,27,000
	iii	Other current liability	4	73,000
	iv.	Short-term provisions	5	19,620
		Total		**8,14,350**
Assets				
1.	**Non-current assets**			
	i	PPE (Property, Plant & Equipment)	6	2,04,160
	ii	Non-current investments		7,500
2.	**Current assets**			
	i	Current investments		4,500
	ii	Inventories	7	85,800
	iii	Trade receivables		2,38,500
	iv	Cash and cash equivalents		2,71,100
	v	Short-term loans and advances	8	2,490
	vi	Other current assets	9	300
		Total		**8,14,350**

Oliva Company Ltd.
Statement of Profit and loss for the year ended 31.03.2019

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	Particulars	Notes	(₹ in '000)
I.	Revenue from operations		17,10,000
II.	Other income (3,900 +300)		4,200
III.	**Total Revenue (I + II)**		**17,14,200**
IV.	**Expenses:**		
	Cost of materials consumed	10	12,64,200
	Changes in inventories of finished goods, work-inprogress and inventory-in-Trade	11	(13,500)
	Employee benefit expenses	12	44,700
	Finance costs		18,240
	Other Expenses	13	3,51,510
	Total Expenses		**16,65,150**
V.	**Profit Before Tax (III - IV)**		49,050
VI.	Tax expense (40% of 49,050)		19,620
VII.	Profit for the period from continuing operations		**29,430**

Notes to accounts

	Reserves and Surplus		
	Profit & loss (Surplus)	48,000	
	Add: Profit for the period	29,430	
	Less: Interim Dividend including DDT	(27,000)	50,430
2.	**Long term borrowing**		
	Secured loans (21,000 less current maturities 1,000)	20,000	
	Fixed Deposits: Unsecured	3,300	23,300
3.	**Short – term borrowings**		
	Secured loans	4,500	
	Fixed Deposits -Unsecured	1,500	6,000
4.	**Other current liabilities**		
	Expenses Payable (67,500 + 4,500)	72,000	
	Current maturities of longterm borrowings	1,000	73,000
5.	**Short term provisions**		

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	Provision for Income tax		19,620
6.	**Property, plant & equipment**		
	Building	1,01,000	
	Less: Depreciation @ 2%	(2,020)	98,980
	Plant & Machinery	70,400	
	Less: Depreciation @10%	(7,040)	63,360
	Furniture	10,200	
	Less: Depreciation @10%	(1,020)	9,180
	Motor vehicles	40,800	
	Less: Depreciation @20%	(8,160)	32,640
	Total		**2,04,160**
7.	**Inventory:**		
	Raw Material	25,800	
	Finished goods	60,000	85,800
8.	**Short term Loans & Advances**		
	General Charges prepaid		2,490
9.	**Other Current Assets:**		
	Interest accrued		300
10.	**Cost of material consumed**		
	Opening inventory of raw Material & Stores	30,000	
	Add: Purchases	12,15,000	
	Stores & Spare parts consumed	(45,000)	
		12,90,000	
	Less: Closing inventory	(25,800)	12,64,200
11.	**Changes in inventory of Finished Goods & WIP**		
	Closing Inventory of Finished Goods	60,000	
	Less: Opening Inventory of Finished Goods	(46,500)	13,500
12.	**Employee Benefit expenses**		
	Salary & Wages (40,200 + 4,500)		44,700
13.	**Other Expenses:**		
	Manufacturing Expenses (2,70,000 + 67,500)	3,37,500	
	General Charges (16,500 – 2,490)	14,010	3,51,510

Computation of Effective Capital

	₹
Paid up equity share capital	
15,000, 14% Preference shares	15,00,000
1,20,000 Equity shares	96,00,000
Reserve excluding Revaluation reserve	45,000
Securities premium	50,000

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15% Debentures	65,00,000
	1,76,95,000
Less: Profit and Loss account (Dr. balance)	15,25,000
Investments	75,00,000
Effective capital	**86,70,000**

Illustration 10

The following is the extract of Balance Sheet of Jupiter Ltd. as at 31st March 2021:

	Rs.
Equity and Liabilities	
Authorized Capital:	
40,000, 14% preference shares of Rs. 100	40,00,000
4,00,000 Equity shares of Rs. 100 each	4,00,00,000
	4,40,00,000
Issued and Subscribed Capital:	
30,000, 14% Preference Shares of Rs.100 each, fully paid up	30,00,000
2,40,000 Equity Shares of Rs.100 each, Rs.80 paid-up	1,92,00,000
Share Suspense Account	40,00,000
Reserve & Surplus:	
Capital reserves (60% is revaluation reserve)	5,00,000
Securities Premium	1,00,000
Secured loans:	
15% Debentures	1,30,00,000
Unsecured loans:	
Public deposits	7,40,000
Cash credit loan from IDBI (short term)	9,30,000
Current Liabilities:	
Trade payables	6,90,000
Assets	
Investment in Shares, debentures, etc.	1,50,00,000
Profit and Loss Account	30,50,000
Preliminary expenses not written off	1,10,000

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

Jupiter Ltd. has been incurring losses for the last few years. Jupiter Ltd. has only one whole-time director.

You are required to compute effective capital as per provisions of schedule V to the Companies Act, 2013. Would your answer differ if Jupiter Ltd. is an investment company?

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Also calculate the amount of maximum remuneration that can be paid if no special resolution is passed at the general meeting of the company in respect of payment for a period not exceeding three years.

Solution: Illustration 10

Calculation of effective capital

Particulars	**Non-Investment**	**Investment**
Preference Share capital	30,00,000	30,00,000
Equity Shares capital	1,92,00,000	1,92,00,000
Capital Reserves (excluding revaluation Reserve)	2,00,000	2,00,000
Securities Premium	1,00,000	1,00,000
15% Debentures	1,30,00,000	1,30,00,000
Public Deposits	7,40,000	7,40,000
Total (A)	**362,40,000**	**362,40,000**
Investments	1,50,00,000	-
Profit and Loss Account (Dr. balance)	30,50,000	30,50,000
Preliminary Expenses not written off	1,10,000	1,10,000
Total (B)	**181,60,000**	**31,60,000**
Effective Capital [A – B]	1,80,80,000	3,30,80,000

Effective capital of the company for both the situations is less than 5 crores. Hence maximum remuneration payable to director should be @ ₹60,00,000 per annum.

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CHAPTER 3 - CASH FLOW STATEMENT

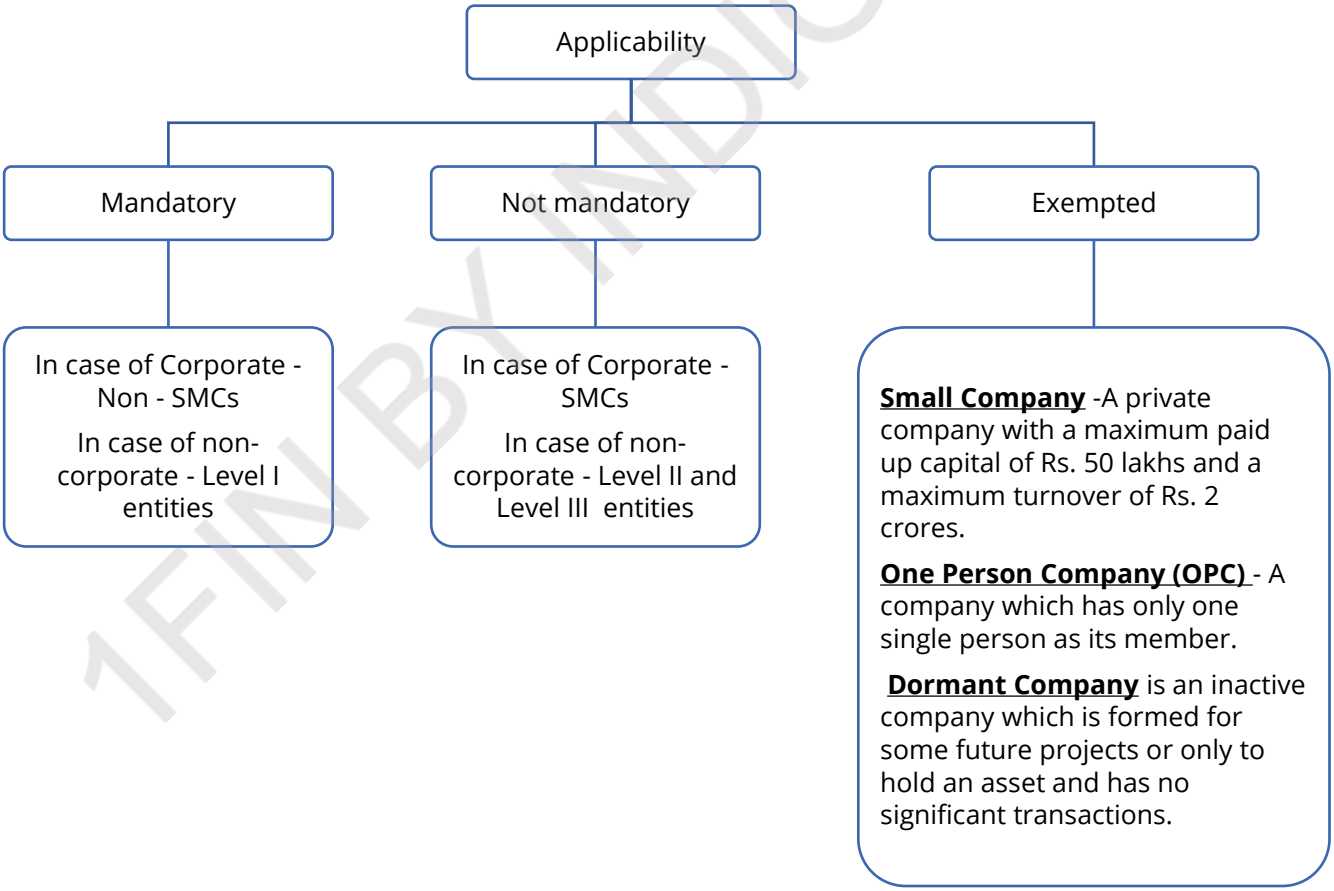
1. Introduction

- Cash flow Statement (CFS) is an *additional information* provided to the users of accounts in the form of an statement, which reflects the various sources from where cash was generated (inflow of cash) by an enterprise during the relevant accounting year and how these inflows were utilized (outflow of cash) by the enterprise.
- Cashflows explain the cash movements between two points of time.
- Any transaction, which *does not result in cash flow*, should not be reported.

E.g.: Conversion of Debt into Equity, Depreciation charges, Acquisition of asset by issuing shares. Etc.

- *Movements within* cash or cash equivalents are not cash flows.
- A break-up of opening and closing cash shown as a note to cash flow statement.
- *Fundamental technique* of cash flow preparation – It is difficult to compile a summary of cash transactions from cashbooks due to the large volume of transactions. Thus, it is possible to compile such a summary by comparing financial statements at the beginning and at the end of accounting period.

2. Applicability



Objective

- To identify the *historical changes* in the flow of cash & cash equivalents.
- To determine the *future requirement* of cash & cash equivalents.

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

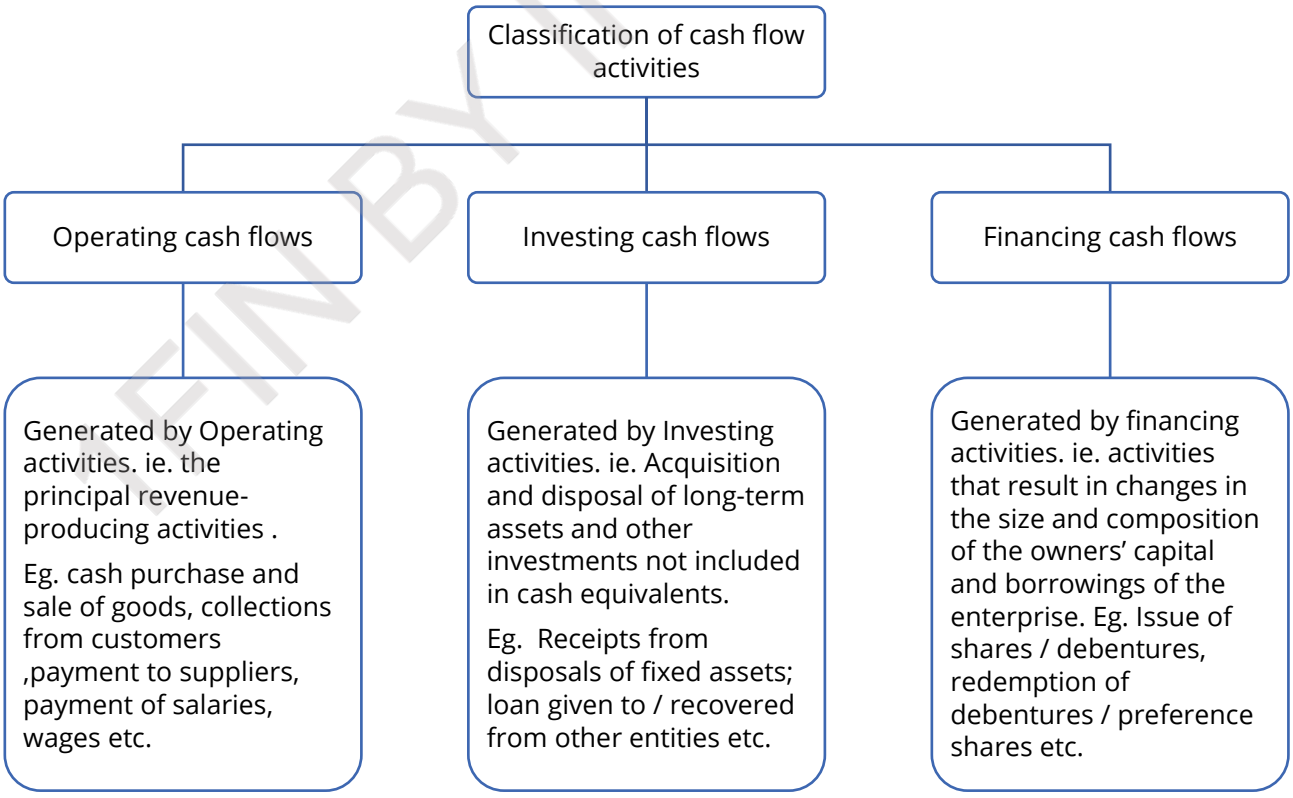
Benefits

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

Cash And Cash Equivalents

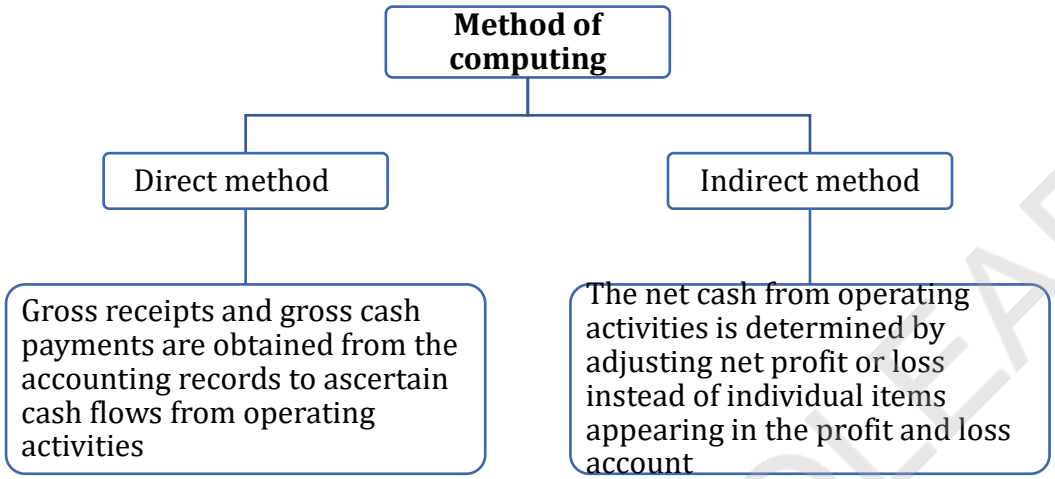
Cash	Cash equivalents
Cash in hand	Short term highly liquid investments that are readily convertible into known amounts of cash and which are subject to insignificant risks of changes in value.
Demand deposits with bank (e.g savings/current account)	Securities with short period of say, three months or less.
	Short term deposits (less than 3 months) Preference shares bought near maturity.

3. Types Of Cash Flow



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



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

Format for Cash Flow from Operating activities under Direct method

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

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Format for Cash Flow from Operating activities under Indirect method

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

CLASSIFICATION OF BUSINESS ACTIVITIES

Operating	**Investing**	**Financing**
Inflows		
1.Cash sales 2.Cash from fees, commission and other income 3.Cash received from debtors	1. Proceeds from sale of fixed assets 2. Proceeds from sale of non-current assets 3.Interest received on debentures 4. Dividend received on shares	1. Proceeds from issue of shares / debentures 2. Loan raised (both long term and short term) 3.Increase in bank overdraft or cash credit
Outflows		
1. Cash purchases 2.Cash paid for operating expenses like salaries, rent etc 3. Cash paid to creditors 4. Payment of Income tax	1. Purchase of fixed assets 2. Purchase of non-current assets	1.Payment for buy back of equity shares 2.Redemption of Preference shares/Debentures 3.Repayment of loans 4.Payment of dividend 5. Payment of Interest on loans 6. Payment of preliminary expenses 7. Decrease in bank overdraft or cash credit

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

Format for Cash Flow statement under Indirect method

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

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TREATMENT OF SPECIFIC ITEMS

★ Loans/Advances given, and Interests earned

Operating CF

Operating Cash Flow

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

Investing Cash Flow

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

★ Loans/Advances taken, and Interests paid

Operating Cash Flow

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

Financing Cash Flow

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

- **Extraordinary cash flows**

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

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- **Investments made and dividends earned**

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

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

Operating Cash Flow
- Tax paid on operating income
- Tax deducted at source on operating income and operating expense

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

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

- **Interest and Dividends**

Operating Cash Flow
- In case of financial enterprises- interest paid and interest and dividends received

Investing Cash Flow
- In case of non-financial enterprises- interest and dividends received

Financing cash flow
- In case of all enterprises – Dividends paid

★ Exchange gains and losses

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

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- **Business Purchase**

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

- **Reporting Cash Flows on Net Basis**

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

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

5. Disclosures

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

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- The portion of the purchase or disposal consideration discharged by means of cash and cash equivalents.

Illustrations

Illustration 1 ***(Direct Method – CF from operating activity – III-1)***

From the following information, calculate cash flow from operating activities:

Summary of Cash Account for the year ended March 31, 20X1			
Particulars	**Amount (Rs.)**	**Particulars**	**Amount (Rs.)**
To Balance b/d	1,00,000	By Cash Purchases	1,20,000
To Cash sales	1,40,000	By Trade payables	1,57,000
To Trade receivables	1,75,000	By Office & Selling Expenses	75,000
To Trade Commission	50,000	By Income Tax	30,000
To Sale of Investment	30,000	By Investment	25,000
To Loan from Bank	1,00,000	By Repay of Loan	75,000
To Interest & Dividend	1,000	By Interest on loan	10,000
		By Balance c/d	1,04,000
	5,96,000		5,96,000

Solution: Illustration 1 **(Direct Method – CF from operating activity – III-1)**

Particulars	**₹**
I. Cash flow from operating Activities:	
• Cash received from Sales	1,40,000
• Cash received from Debtors	1,75,000
• Commission Received	50,000
• Purchases	(1,20,000)
• Payment to creditors	(1,57,000)
• Office & Selling Expenses	(75,000)
Cash Generated from Operations	**13,000**
Less: Income Tax	(30,000)
Net Cash used in Operations	**(17,000)**

Illustration 2 ***(CF from Investing Activities – III – 2 : Example)***

In a year the company has made sales of Rs.10,000. From the extracts given, prepare ledger accounts to arrive at money paid by or paid to debtors and creditors respectively.

Profit and Loss Account.

Debit	(Rs.)	Credit	(Rs.)
To Purchases	7,000	By Sales	
Cash – 2000		Cash – 6000	
Credit 5000		Credit - 4000	10,000

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To Bad Debt	200		

Particulars	Year 1 (Rs.)	Year 2 (Rs.)
Debtors – closing	1,000	1,200
Trade payables - closing	500	600

Solution

Debtors A/c

Debit	(Rs.)	Credit	(Rs.)
To Bal b/d	1,000	By Bank (Bal. fig)	3,600
To Sales	4000	By Bad Debts	200
		By bal C/d	1,200
	5,000		**5,000**

Cash flow from sales = Cash Sales + Receipts from Debtors = 6,000 + 3,600 = 9,600

Trade Payables A/c

Debit	(Rs.)	Credit	(Rs.)
To Bank (bal Fig)	4,900	By bal b/d	500
To Bal c/d	600	By Purchases	5,000
	5,500		**5,500**

Cash paid to Suppliers = Cash Purchases+ Payments to Creditors= 2,000 + 4,900 = 6,900

Illustration 3 ***(CF from Financing Activities- III – 3)***

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

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

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

Solution: **Illustration 3 (CF from Financing Activities- III – 3)**

Particulars	**₹**
I. Cash flow from Financing Activities:	
• Proceeds From Issue of debentures	2,15,000
• Interest Paid on Debentures	(1,07,500)
Cashflow From Financing Activity	**1,07,500**

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Workings:

15% Debenture A/c

	₹		₹
		By Balance b/d	5,00,000
		By Discount on Issue of Debentures	35,000
To Balance c/d	7,50,000	By Bank (Bal. Fig)	2,15,000
	7,50,000		**7,50,000**

Discount on Issue of debentures

	₹		₹
To Balance C/d	90,000	By P&L	10,000
To 15% Debentures	35,000	By Balance c/d	1,15,000
	1,25,000		**1,25,000**

Interest Payable, assumed issued as beginning of the year i.e. 7,50,000 × 15% = 1,12,500

Therefore, Interest Paid= 1,12,500 – 5000 = 1,07,500

Illustration 4

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

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

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

The company does not have any cash equivalents.

Solution 4

Cash Flow Statement for the year ended 31st March, 20X2 (Using direct method)

Particulars		**₹ ('000)**
I. Cash flow from operating Activities:		
• Cash receipts from customers	2,783	
• Cash payments to suppliers	(2,047)	
• Payment for overheads	(115)	
• Wages/ Salaries	(69)	

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Cash generated from operations	552	
Less: Income tax paid	(243)	
Net cash from operating activities		309
II. Cash flows from investing activities		
• Sale of fixed assets	128	
• Payments for purchase of fixed assets	(230)	
Net cash used in investing activities		(102)
III. Cash flows from financing activities:		
• Proceeds from issuance of share capital	300	
• Dividend paid	(80)	
• Bank loan repaid	(250)	
Net cash used in financing activities		(30)
Net increase in cash and cash equivalents		177
Cash and cash equivalents at beginning of period		35
Cash and cash equivalents at end of period		**212**

Illustration 5

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

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

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

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Balance	30

Relevant Balance Sheet Information:

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

Compute cash flow from operating activities using

1. Direct method and
2. Indirect method

Solution: Illustration 5

Cash Flow from Operating Activities (Direct Method)

Particulars	**₹ in lakhs**
Cash collection from Trade receivables	4,000
Cash payment to Trade payables	(2,380)
Cash Paid towards wages	(790)
Cash expenses (200 + 10 – 20)	(190)
Cash generated from operations before Taxes	640
Less: Taxes paid – Advance tax	(195)
Cash generated from operations	**445**

Indirect Method

Particulars	**₹ in lakhs**
Net Profit Before Taxation	710
Add: Non - Cash items:	
• Depreciation	100
Add/Less: Items under other Heads	
• Less: interest and Dividend (investment cash inflow)	(100)
• Add: Interest expense (Financing cash outflow)	60
Operating Profit Before Working Capital Changes	**770**
Changes in working Capital:	
Increase in Inventories (180 – 200)	(20)
Increase in Trade receivables (250 – 400)	(150)
Increase in Trade payables (250 – 230)	20
Increase in outstanding Expense (20 - 10)	10
Increase in Outstanding wages (50 – 40)	10
Cash flow from operating activities before taxes	**640**

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Less: Taxes Paid	**(195)**
Cash generated from operations	**445**

Workings:

Trade Receivable

	₹		₹
To Balance b/d	250	By Bank (Bal. fig)	4,000
To Sales	4,150	By Balance c/d	400
	4,400		**4,400**

Trade Payables

	₹		₹
To Bank (Bal. fig)	2380	By Balance b/d	230
To Balance c/d	250	By Purchases	2,400
	2,630		**2,630**

Wages Payable

	₹		₹
To Bank (Bal. fig)	790	By Balance b/d	40
To Balance c/d	50	By Wages	800
	840		**840**

Provision for Tax

	₹		₹
To Advance Tax	180	By P/L	200
To Balance b/d	200	By Balance c/d	180
	380		**380**

Advance Tax

	₹		₹
To Balance b/d	180	By Provision for Tax	180
To Bank (Bal fig)	195	By Balance c/d	195
	375		**375**

Illustration 6

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

1. Company sold goods for cash only
2. Gross Profit Ratio was 30% for the year, gross profit amounts to Rs.3,82,500.
3. Opening inventory was less than closing inventory by Rs.35,000
4. Wages paid during the year Rs.4,92,500
5. Office & selling expenses paid during the year Rs.75,000
6. Dividend paid during the year Rs. 30,000 (including dividend distribution tax)
7. Bank loan repaid during the year Rs.2,15,000 (including interest Rs.15,000)
8. Trade payables on 31st March, Year 0 exceed the balance on 31st March Year 1 by Rs.25,000
9. Amount paid to trade payables during the year Rs.4,60,000
10. Tax paid during the year amounts to Rs.65,000 (Provision for taxation as on 31st March of Year 1 Rs.45,000)

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11. Investments of Rs.7,00,000 sold during the year at a profit of Rs.20,000
12. Depreciation on fixed assets amounts to Rs.85,000
13. Plant and Machinery purchased on 15th November of Year 0 for Rs.2,50,000
14. Cash and Cash equivalents on 31st March of Year 0 - Rs.2,00,000
15. Cash and Cash equivalents on 31st March of Year 1 – Rs.6,07,500

Solution: Illustration 6

Cash Flow Statement for the year ended 31st March, 20X1 (Using direct method)

Particulars	**₹**	**₹**
I. Cash flow from Operating Activities:		
Cash Collected from Customer (Working Note 1)		12,75,000
Less: Cash payments for trade payables	(4,60,000)	
Wages Paid	(4,92,500)	
Office and selling expenses	(75,000)	(10,27,500)
Cash generated from operations before taxes		2,47,500
Less: Taxes Paid		(65,000)
Net cash generated from operating activities		**1,82,500**
II. Investing Activities:		
Sale of investments (7,00,000 + 20,000)	7,20,000	
Payments for purchase of Plant & machinery	(2,50,000)	
Net cash generated from investing activities		**4,70,000**
III. Cash flows from financing activities:		
Dividend paid (including dividend distribution tax)	(30,000)	
Bank loan repayment	(2,00,000)	
Interest on loan	(15,000)	
Net cash used in financing activities		**(2,45,000)**
Net increase in cash		**4,07,500**
Cash and cash equivalents at beginning of the period		**2,00,000**
Cash and cash equivalents at end of the period		**6,07,500**

Working Notes:

1. Sales

GP Ratio = 30%

=> Gross Profit / Sales = 30%

=> Sales = ₹3,82,500/ 30% = 12,75,000

Illustration 7

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

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

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

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

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

(5) Dividend paid during the year amounted to Rs. 11.7 crores (including Dividend distribution tax) was also paid.

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(6) Investment costing Rs.12 crores were sold at a profit of Rs. 2.4 crores.

(7) Rs. 8 crores were paid towards income tax during the year.

(8) A new plant costing Rs. 21 crores were purchased in part exchange of an old plant. The book value of the old plant was Rs.12 crores but the vendor took over the old plant at a value of Rs.10 crores only. The balance was paid in cash to the vendor.

(9) The following balances are also provided:

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

Solution: Illustration 7

Gamma Ltd.

Cash Flow Statement for the year ended 31st March, 20X1 (Using direct method)

Particulars	**₹ in crores**	**₹ in crores**
I. Cash flow from Operating Activities:		
• Cash sales (WN 1)	81	
• Cash collected from Debtors (WN 1)	49	
• Cash purchases (20% of 55)	(11)	
• Cash payments to suppliers (WN 2)	(42)	
• Cash paid towards Admin. & Selling	(18)	
• Cash paid to employees	(22)	
Cash generated from operations before Tax	37	
Less: Income Tax Paid	(8)	
Net cash generated from operating activities		**29**
II. Cashflow from investing activities:		
• Sale of investments (12+2.40)	14.4	
• Payments for purchase of fixed assets (21 – 10)	(11)	
Net cash generated from investing activities		**3.4**
Cash flows from financing activities		
• Redemption of debentures (22-15)	(7)	
• Interest paid on debentures	(1.5)	
• Dividend paid	(11.7)	
Net cash used in financing activities		**(20.2)**
Net increase in cash and cash equivalents		**12.2**
Cash at beginning of the period		**6.0**
Cash at end of the period		**18.2**

Working Note:

1. Cash collected from Sales

Total Sales = 135

Cash sales = 60% of 135 = 81 Crores

Credit Sales = 54

Debtors A/c (Amount collected) (**crores)**

	₹		**₹**
To Balance b/d	45	By Bank (bal. fig)	49

To Sales	54	By Balance c/d	50
	99		**99**

2. Creditors A/c

	₹		₹
To Bank (bal. fig)	42	By Balance b/d	21
To Balance c/d	23	By Purchases (55x80%)	44
	65		**65**

3. Cash paid to Debt holders

Face value of debentures = 20 Crores
Add: Premium (10% of 20) = 2 Crores
Total amount Payable = 22 Crores
Less: Equity Shares issued = (15)
Cash paid = 7 Crores

Illustration 8

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

Balance Sheets of Mr. Zen

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

Additional information:

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

Solution: Illustration 8

Cash Flow Statement of Mr. Zen as per AS 3 for the year ended 31.3.20X1

Particulars	**₹**
(i) Cash flow from operating activities	
Net Profit (given)	3,60,000
Add: Non-Cash Depreciation	1,44,000
Add: Investment Related – Loss on sale of Plant & Machinery	16,000

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Operating Profit before working capital changes	5,20,000
Adjustments working Capital	
Add: Decrease in inventory	80,000
Less: Increase in trade receivables	(1,60,000)
Add: Increase in trade payables	32,000
Net cash generated from operating activities	**4,72,000**
(ii) Cash flow from investing activities	
• Cash Paid to purchase of P&M	(4,40,000)
• Sale of Machinery (W.N.1)	40,000
• Cash received on Sale of land	1,60,000
Net cash used in investing activities	**(2,40,000)**
(iii) Cash flow from financing activities	
• Loan availed from bank	80,000
• Repayment of Mrs. Zen's Loan	(2,00,000)
• Drawings (W.N.2)	(1,36,000)
Net cash used in financing activities	**(2,56,000)**
Net decrease in cash	**(24,000)**
Opening balance as on 1.4.20X0	**80,000**
Cash balance as on 31.3.20X1	**56,000**

Working Notes:

1.Fixed Assets

	20X0	**20X1**
WDV	6,40,000	8,80,000
Depreciation (Accumulated)	2,00,000	3,20,000
Cost (Gross Block)	**8,40,000**	**12,00,000**

Plant & Machinery A/c

	₹		**₹**
To Balance b/d	8,40,000	By Asset Disposal	80,000
To Bank (Purchase of P/M)	4,40,000		
(Bal.fig)		By Balance C/d	12,00,000
	12,80,000		**12,80,000**

Provision for depreciation on Plant and Machinery A/c

	₹		**₹**
To asset Disposal	24,000	By Balance b/d	2,00,000
To Balance c/d	3,20,000	By Depreciation (Bal.fig)	1,44,000
	3,44,000		**3,44,000**

Asset Disposal A/C

	₹		**₹**
To Plant & Machinery	80,000	By Provision for Deprecia.	24,000
		By Bank	40,000
		By P/L (Loss on sale)	16,000
	80,000		**80,000**

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2.To find out Mr. Zen's drawings:

Capital a/c

	₹		₹
To Bank (Drawings) Bal. fig.	1,36,000	By Bal b/d	10,00,000
To Balance c/d	12,24,000	By P/L	3,60,000
	13,60,000		**13,60,000**

Illustration 9

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

	(Rs. In lakhs)
Net Profit	25,000
Dividend (including dividend tax) paid	8,535
Provision for Income tax	5,000
Income tax paid during the year	4,248
Loss on sale of assets (net)	40
Book value of the assets sold	185
Depreciation charged to Profit & Loss Account	20,000
Profit on sale of Investments	100
Carrying amount of Investment sold	27,765
Interest income on investments	2,506
Interest expenses of the year	10,000
Interest paid during the year	10,520
Increase in Working Capital (excluding Cash & Bank Balance)	56,081
Purchase of fixed assets	14,560
Investment in joint venture	3,850
Expenditure on construction work in progress	34,740
Proceeds from calls in arrear	2
Receipt of grant for capital projects	12
Proceeds from long-term borrowings	25,980
Proceeds from short-term borrowings	20,575
Opening cash and Bank balance	5,003
Closing cash and Bank balance	6,988

Prepare the Cash Flow Statement for the year 20X1 in accordance with AS 3.

Solution: Illustration 9

Star Oils Limited Cash Flow Statement for the year ended 31st March, 20X1

	(₹ in lakhs)
I. Cash flows from operating activities	
Net profit (before taxation) (25,000 + 5,000)	30,000
Add: Depreciation (Non – Cash)	20,000
Loss on sale of assets (Net)	40
Less: Profit on sale of investments	(100)
Less: Interest income on investments	(2,506)

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Add: Interest expenses	10,000
Operating profit before working capital changes	57,434
Increase in working capital (Excluding cash and bank balance)	(56,081)
Cash generated from operations before Taxes	1,353
Income taxes paid	(4,248)
Net cash used in operating activities	**(2,895)**
II. Cash flows from investing activities	
• Sale of assets (185 – 40)	145
• Sale of investments (27,765 + 100)	27,865
• Interest income on investments *	2,506
• Purchase of fixed assets	(14,560)
• Investment in joint venture	(3,850)
• Purchase of fixed assets	(14,560)
• Expenditure on construction work-in progress	(34,740)
• Net cash used in investing activities	**(22,634)**
Cash flows from financing activities	
• Proceeds from calls in arrear	2
• Receipts of grant for capital projects	12
• Proceeds from long-term borrowings	25,980
• Proceed from short-term borrowings	20,575
• Interest paid	(10,520)
• Dividend (including dividend tax) paid	(8,535)
Net cash generated from financing activities	**27,514**
Net increase in cash and cash equivalents	1,985
Cash and cash equivalents at the beginning of the period	5,003
Cash and cash equivalents at the end of the period	**6,988**

* Assumed interest income fully received

Illustration 10

The following data were provided by the accounting records of Ryan Ltd. at year-end, March 31, 20X1:
Income Statement

	(Rs.)	**(Rs.) Rs.**
Sales		6,98,000
Cost of Goods Sold		(5,20,000)
Gross Margin		1,78,000
Operating Expenses		
(including Depreciation Expense of Rs.37,000/-)		(1,47,000)
		31,000
Other Income / (Expenses)		
Interest Expense paid	(23,000)	
Interest Income received	6,000	
Gain on Sale of Investments	12,000	
Loss on Sale of Plant	(3,000)	

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		(8,000)
		23,000
Income tax		(7,000)
		16,000

Comparative Balance Sheets

	31st March 20X1	31st March 20X0
Assets		
Plant Assets	7,15,000	5,05,000
Less: Accumulated Depreciation	(1,03,000)	(68,000)
	6,12,000	4,37,000
Investments (Long term)	1,15,000	1,27,000
Current Assets:		
Inventory	1,44,000	1,10,000
Accounts receivable	47,000	55,000
Cash	46,000	15,000
Prepaid expenses	1,000	5,000
	9,65,000	7,49,000
Liabilities		
Share Capital	4,65,000	3,15,000
Reserves and surplus	1,40,000	1,32,000
Bonds	2,95,000	2,45,000
Current liabilities:		
Accounts payable	50,000	43,000
Accrued liabilities	12,000	9,000
Income taxes payable	3,000	5,000
	9,65,000	7,49,000

Analysis of selected accounts and transactions during 20X0-X1

1. Purchased investments for Rs.78,000/-.
2. Sold investments for Rs.1,02,000/-. These investments cost Rs.90,000/-.
3. Purchased plant assets for Rs.1,20,000/-.
4. Sold plant assets that cost Rs.10,000/- with accumulated depreciation of Rs. 2,000/- for Rs.5,000/-.
5. Issued Rs.1,00,000/- of bonds at face value in an exchange for plant assets on 31st March, 20X1.
6. Repaid Rs.50,000/- of bonds at face value at maturity.
7. Issued 15,000 shares of Rs. 10/- each.
8. Paid cash dividends Rs. 8,000/-.

Prepare Cash Flow Statement as per AS-3 (Revised), using indirect method.

Solution: Illustration 10

Cash Flow Statement of Ryan Limited

Particulars	**₹**	**₹**
I. Cash flows from operating activities		
Net profit before taxation	23,000	
Add: Depreciation	37,000	

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Add: Interest expense	23,000	
Less: Interest income	(6,000)	
Gain on sale of investments	(12,000)	
Loss on sale of plant assets	3,000	
Operating profit before working capital changes		68,000
Adjustments for Working Capital changes:		
Less: change in Inventory - Increase	(34,000)	
Add: Decrease in Receivable	8,000	
Add: Decrease in prepaid expenses	4,000	
Add: Increase in accounts payable	7,000	
Add: Increase in accrued liabilities	3,000	
Operating Cash flow before taxes	56,000	
Income taxes paid	(9,000)	
Net cash generated from operating activities		47,000
II. Cash flows from investing activities		
Purchase of plant	(1,20,000)	
Sale of plant	5,000	
Purchase of investments	(78,000)	
Sale of Investments	1,02,000	
Interest received	6,000	
Net cash used in investing activities		(85,000)
III. Cash flows from financing activities		
Proceeds from issuance of share capital (465-315)	1,50,000	
Dividends paid	(8,000)	
Repayment of bonds (2,45,000 + 1,00,000 – 2,95,000)	(50,000)	
Interest paid	(23,000)	
Net cash from financing activities		69,000
Net increase in cash and cash equivalents		**31,000**
Cash and cash equivalents at the beginning of the period		**15,000**
Cash and cash equivalents at the end of the period		**46,000**

Working Notes:

1. Income Tax Paid

Income Tax Paid

	₹		₹
To Bank (Bal. fig)	9,000	By Bal b/d	5,000
To Balance c/d	3,000	By P/L (Current year Provision)	7,000
	12,000		**12,000**

2.

Plant Assets

	₹		₹
To Balance b/d	5,05,000	By Asset Disposal	10,000
To Bonds	1,00,000	By Depreciation	7,15,000

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To Bank (Bal. fig)	1,20,000		
	7,25,000		**7,25,000**

Accumulated Depreciation

	₹		₹
To Asset Disposal (Bank)	2,000	By Bal b/d	68,000
To Balance c/d	1,03,000	By Depreciation	37,000
	1,05,000		**1,05,000**

Asset Disposal

	₹		₹
To Plant Assets	10,000	By Accumulated Depreciation	2,000
		By Bank	5,000
		By P/L (Loss)	3,000
	10,000		**10,000**

3.

Investment (at Cost)

	₹		₹
To Balance b/d	1,27,000	By Bank	1,02,000
To P/L	12,000	(90,000 + 12.000)	
To Bank (Bal. fig)	78,000	By Balance c/d	1,15,000
	2,17,000		**2,17,000**

4. Dividend Paid

Reserves and Surplus

	₹		₹
To Dividend Paid (Bank) Bal.fi	8,000	By Bal b/d	1,32,000
To Balance c/d	1,48,000	By P/L (Profits for the year)	16,000
	1,48,000		**1,48,000**

Illustration 11

From the following Balance Sheet and information, prepare Cash Flow Statement of Ryan Ltd. by Indirect method for the year ended 31st March, 20X1:

Liabilities	31st March, 20X1	31st March, 20X0	Assets	31st March, 20X1	31st March, 20X0
Equity Share Capital	6,00,000	5,00,000	Land and Building	1,50,000	2,00,000
10% Redeemable Preference Share Capital	•	2,00,000	Plant and Machinery	7,65,000	5,00,000
Capital Redemption Reserve	1,00,000	-	Investments	50,000	80,000
Capital Reserve	1,00,000	•	Inventory	95,000	90,000

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General Reserve	1,00,000	2,50,000	Trade receivables	2,50,000	2,25,000
Profit & Loss Account	70,000	50,000	Cash and Bank	65,000	90,000
9% Debentures	2,00,000	-	Voluntary Separation Payments	1,25,000	65,000
Trade payables	1,15,000	1,10,000			
Liability for Expenses	30,000	20,000			
Provision for Taxation	95,000	60,000			
Dividend Payable	90,000	60,000			
	15,00,000	**12,50,000**		**15,00,000**	**12,50,000**

Additional Information:

- A piece of land has been sold out for Rs.1,50,000 (Cost – Rs.1,20,000) and the balance land was revalued. 4960Capital Reserve consisted of profit on sale and profit on revaluation.
- On 1st April, 20X0 a plant was sold for Rs.90,000 (Original Cost – Rs.70,000 and W.D.V. – Rs.50,000) and Debentures worth Rs.1 lakh was issued at par as part consideration for plant of Rs.4.5 lakhs acquired.
- Part of the investments (Cost – Rs.50,000) was sold for Rs.70,000.
- Pre-acquisition dividend received Rs.5,000 was adjusted against cost of investment.
- Directors have declared 15% dividend for the current year.
- Voluntary separation cost of Rs.50,000 was adjusted against General Reserve.
- Income-tax liability for the current year was estimated at Rs.1,35,000.
- Depreciation @ 15% has been written off from Plant account but no depreciation has been charged on Land and Building.

Solution: Illustration 11

Particulars	**₹**	**₹**
I. Cash flows from operating activities		
Net Profit after taxation (W.N.1)	1,10,000	
Add: Provision for taxation	1,35,000	
Net Profit before taxation		2,45,000
Add/Less		
• Depreciation	1,35,000	
• Gain on Sale of Plant	(40,000)	
• Gain on Sale of Investment (70,000 – 50,000)	(20,000)	
• Interest on Debentures (9% of Debentures)	18,000	93,000
Operating Profit Before working Capital Changes		3,38,000
Increase in Inventories	(5,000)	
Increase in trade receivables	(25,000)	
Increase in trade payables	5,000	
Increase in liabilities for expenses	10,000	(15,000)
Cash generated from operations		3,23,000

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Less: Taxes Paid		(1,00,000)
		2,23,000
Voluntary Separation payment		(1,10,000)
Net cash generated from operating activities		1,13,000
Cash flow from investing activities		
Proceeds from sale of land (W.N.11)	1,50,000	
Proceeds from sale of plant (W.N.8)	90,000	
Purchase of plant (W.N.7)	(3,50,000)	
Proceeds from sale of investments (W.N.12)	70,000	
Pre-acquisition dividend received	5,000	
Purchase of investments (W.N.12)	(25,000)	
Net cash used in investing activities		(60,000)
Cash flow from financing activities		
Proceeds from issue of equity shares (6,00,000 – 5,00,000)	1,00,000	
Redemption of preference shares	(2,00,000)	
Proceeds from issue of debentures (2,00,000 – 1,00,000)	1,00,000	
Payment of Interest	(18,000)	
Dividends paid	(60,000)	
Net cash used in financing activities		(78,000)
Net decrease in cash and cash equivalents		(25,000)
Cash and cash equivalents at the beginning of the year		90,000
Cash and Cash equivalents at the end of the year		65,000

Working Notes:

1. Net Profit

Profit and Loss Account

	₹		₹
To Dividend Payable (15% of 6,00,000)	90,000	By Balance b/d	50,000
To balance c/d	70,000	By Profit for 20X1 (Balancing Fig.)	1,10,000
	1,60,000		**1,60,000**

2. General Reserve A/c

	₹		₹
To Voluntary separation cost	50,000	By Balance b/d	2,50,000
To CRR	1,00,000		
To balance c/d	1,00,000		
	2,50,000		**2,50,000**

3. Capital Redemption Reserve A/c

	₹		₹
		By Balance b/d	-
To balance c/d	1,00,000	By General Reserve	1,00,000

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	1,00,000		**1,00,000**

4. Capital Reserve

	₹		₹
		By Balance b/d	-
To balance c/d	1,00,000		
	1,00,000		**1,00,000**

5.Voluntary Separation Cost A/c

	₹		₹
To Balance b/d	65,000	By General Reserve	50,000
To Bank (Balancing Fig.)	70,000	By Balance c/d	1,25,000
	1,75,000		**1,75,000**

6. Redemption of Preference shares

	₹
Face value redeemed	2,00,000
Face value of fresh issue	(1,00,000)
Balance (Transferred from free reserve to CRR)	**1,00,000**

7. Plant and Machinery

	₹		₹
To Balance b/d	5,00,000	By Disposal of Plant	50,000
To Debentures	1,00,000	By Depreciation (15% of 9,00,000)	1,35,000
To Bank	3,50,000	By Bal c/d	7,65,000
	9,50,000		**9,50,000**

8. Disposal of Plant

	₹		₹
To Plant and Machinery	50,000	By Bank	90,000
To Profit on Sale	40,000		
	90,000		**90,000**

9. Provision for Taxation

	₹		₹
To Bank a/c (Bal. Fig)	1,00,000	By Balance b/d	60,000
To Balance c/d	95,000	By Profit and Loss	1,35,000
	1,95,000		**1,95,000**

10 Land and Building A/c

	₹		₹
To Balance b/d	2,00,000	By Disposal of land	1,20,000
To Capital Reserve	70,000	By Balance c/d	1,50,000
	2,70,000		**2,70,000**

11. Disposal of Land

	₹		₹
To Land and Building	1,20,000	By Bank	1,50,000
To Capital Reserve	30,000		

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	1,50,000		**1,50,000**

12. Investment a/c

	₹		₹
To Balance b/d	80,000	By Bank	70,000
		By Bank (Pre acquisition dividend)	5,000
To P&L (Gain on Sale)	20,000	By Balance c/d	50,000
To Bank (Bal. fig) - Purchases	25,000		
	1,25,000		**1,25,000**

Illustration 12

From the following information, prepare a Cash Flow Statement for the year ended 31st March, 2019.

	Particulars	**Note**	**31.03.2019 (Rs.)**	**31.03.2018 (Rs.)**
I	EQUITY AND LIABILITES			
	(1) Shareholder's Funds			
	(a) Share Capital	1	3,50,000	3,00,000
	(b) Reserves and Surplus	2	82,000	38,000
	(2) Non-Current Liabilities			
	(3) Current Liabilities			
	(a) Trade Payables		65,000	44,000
	(b) Other Current Liabilities	3	37,000	27,000
	(c) Short term Provisions (provision for tax)		32,000	28,000
	Total ASSETS		5,66,000	4,37,000
II	(1) Non-current Assets			
	(a) Tangible Assets	4	2,66,000	1,90,000
	(b) Intangible Assets (Goodwill)		47,000	60,000
	Non-Current Investments		35,000	10,000
	(2) Current Assets			
	(a) Inventories		78,000	85,000
	(b) Trade Receivables		1,08,000	75,000
	(c) Cash & Cash Equivalents		32,000	17,000
	Total		5,66,000	4,37,000

Note 1 : Share capital

Particulars	31.03.2019 (Rs.)	31.03.2018 (Rs.)
Equity Share Capital	2,50,000	1,50,000
8% Preference Share Capital	1,00,000	1,50,000
Total	3,50,000	3,00,000

Note 2: Reserves and Surplus

Particulars	**31.03.2019 (Rs.)**	**31.03.2018 (Rs.)**
General Reserve	30,000	20,000
Profit and Loss A/c	27,000	18,000

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Capital Reserve	25,000	
Total	82,000	38,000

Note 3 : Current Liabilities

Particulars	31.03.2019(Rs.)	31.03.2018 (Rs.)
Dividend declared	37,000	27,000

Note 4: Tangible Assets

Particulars	31.03.2019 (Rs.)	31.03.2018 (Rs.)
Land & Building	75,000	1,00,000
Machinery	1,91,000	90,000
Total	2,66,000	1,90,000

Additional Information:

(i) Rs. 18,000 depreciation for the year has been written off on plant and machinery and no depreciation has been charged on Land and Building.

(ii) A piece of land has been sold out for Rs. 50,000 and the balance has been revalued, profit on such sale and revaluation being transferred to capital reserve. There is no other entry in Capital Reserve Account.

(iii) A plant was sold for Rs. 12,000 WDV being Rs. 15,000 on the date of sale (after charging depreciation).

(iv) Dividend received amounted to Rs. 2,100 which included pre-acquisition dividend of Rs. 600.

(v) An interim dividend of Rs. 10,000 including Dividend Distribution Tax has been paid.

(vi) Non-current investments given in the balance sheet represents investment in shares of other companies.

(vii) Amount of provision for tax existing on 31 3.2018 was paid during the year 2018 -19.

Solution: Illustration 12

Cash flow Statement for the year ending 31st March,2019

	₹	₹
I. Cash Flow from Operating Activities		
Closing balance as per Profit and Loss Account		27,000
Less: Opening balance as per Profit and Loss Account		(18,000)
Add: Dividend declared during the year		37,000
Add: Interim dividend paid during the year		10,000
Add: Transfer to reserve		10,000
Add: Provision for Tax		32,000
Net profit before taxation		98,000
Add: Items to be added		
Depreciation	18,000	
Loss on sale of Plant	3,000	

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Goodwill written off	13,000	34,000
Less: Dividend Income		(1,500)
Operating profit before working capital changes		1,30,500
Add: Decrease in Current Assets and Increase in Current Liabilities		
Decrease in Inventories	7,000	
Increase in Trade Payables	21,000	28,000
Less: Increase in Trade Receivables		(33,000)
Cash generated from operations		1,25,500
Less: Income taxes paid		(28,000)
Net Cash from operating activities		97,500
II. Cash Flows from investing activities:		
Purchase of Plant	(1,34,000)	
Sale of Land	50,000	
Sale of plant	12,000	
Purchase of investments	(25,600)	
Dividend Received	2,100	
Net cash used in investing activities		(95,500)
II. Cash Flows from Financing Activities:		
Proceeds from issue of equity share capital	1,00,000	
Redemption of preference shares	(50,000)	
Interim Dividend (inclusive of DDT) paid	(10,000)	
Final dividend (inclusive of DDT) paid	(27,000)	
Net cash from financing activities		13,000
Net increase in cash and cash equivalents		15,000
Cash and cash equivalents at beginning of period		17,000
Cash and cash equivalents at end of period		32,000

Working Notes:

1.

Land and Building Account

	₹		₹
To Balance b/d	1,00,000	By Bank (Sale)	50,000
To Capital Reserve (Profit on sale/revaluation)	25,000		
	1,25,000		**1,25,000**

2.

Plant and Machinery Account

	₹		₹
To Balance b/d	90,000	By Depreciation A/c	18,000
To Bank A/c (Purchase)	1,34,000	By Bank A/c (sale)	12,000
		By Profit and Loss A/c (Loss on sale)	3,000

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		By Balance c/d	1,91,000
	2,24,000		**2,24,000**

3.

Investments Account

	₹		₹
To Balance b/d	10,000	By Bank A/c (Div. received	600
To Bank A/c (Purchase)	25,600	By Balance c/d	35,000
	35,600		**35,600**

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CHAPTER 4 – ACCOUNTING OF BANKING, ELECTRICITY & INSURANCE COMPANIES
UNIT 1 - BANKING COMPANIES

1. Introduction

A **Bank** is a commercial institution which

- accepts, collects, transfers, lends and exchange money both
  - domestically;
  - internationally and
- there by circulates and manages money throughout the economy

In India banks and their activities are governed by **the Banking Regulation Act, 1949.**

Section 5(b) of the Banking Regulation Act, 1949
Banking means,

- Accepting **deposits** of money from public for the purpose of
  - lending or
  - investing
- Deposits are repayable on demand or otherwise, and can be withdrawn by cheque, draft or otherwise.

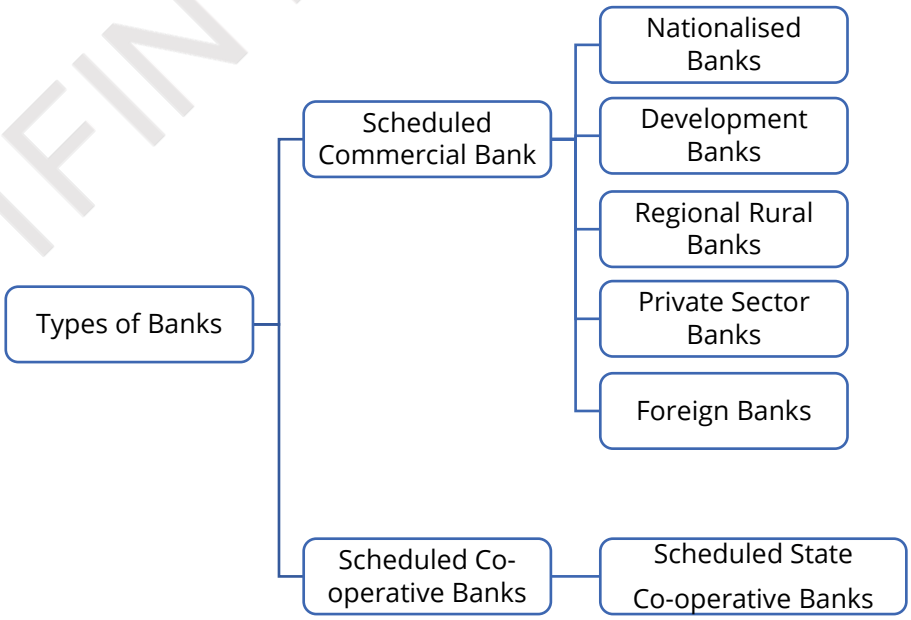
Banking Company

Any bank which transacts this business as stated in section 5 of the act in India is called a banking company.

1.1 Types of Banks

There are two main categories of Commercial Bank in India namely:-

1. Scheduled Commercial Bank
2. Scheduled Co-operative Bank



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1.2 Reserve Bank

The RBI as the Central Bank is the 'Bank of Last Resort' i.e. when other commercial banks are in trouble RBI helps them out.

Services provided by RBI **to scheduled Commercial Banks**

- The purchase, sale, and re-discounting of certain bills of exchange, or promissory note
- Purchase and sale of foreign exchange.
- Purchase, sale and re-discounting of foreign bills of exchange
- Making of loans and advances to scheduled banks.
- Maintenance of accounts of the scheduled bank in its banking department and issue department.
- Remittance of money between different branches of scheduled banks through the offices, branches or agencies of Reserve Bank free of cost or at nominal rates.

1.3 Functions of Commercial Bank

- **Accepting Deposits from the public**
- **Granting of Loans and Advances**: Commercial banks grant loans in the form of overdraft, cash credit and discounting bills of exchange from the deposits.
- **Agency Functions**: Bank functions in the form of agent and represents their customers for the following:
    - For **collecting** cheques, drafts, bills of exchange. Banks also collects dividends, pension, interests on investments etc. on behalf of their customers.
    - Banks arrange to **send** money from one place to another by the way of demand drafts, telegraphic transfers, travellers' cheques, etc.
    - Making **payments** of various obligations on behalf of their customers.
- **Other Functions**:
    - Issuing Letter of Credit, Guarantees.
    - Buying, Selling and dealing in Foreign Exchange
    - Safe custody of securities and valuables.

2. Relevant provisions of the Banking Regulation Act,1949

2.1 Reserve Fund

- Every Indian banking company has to create a Reserve Fund and transfer at least **25% of its profit.**
- The profit of the year as per the P&L account prepared under **Section 29** is to be taken as base.
- Transfer to reserve fund should be made **before declaration of any dividend**.
- If **any appropriation** from the reserve fund or share premium account is made, it has to report to the RBI the reasons for such appropriation within **21 days.**

2.2 Restriction as to Payment of Dividend

No banking company shall pay any dividend on its shares until all its **capitalised expenses** including the following have been completely written off:

- Preliminary Expenses
- Organisation Expenses
- Share Selling Commission
- Brokerage

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- Amount of losses Incurred by tangible assets

2.3. Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR)

Cash Reserve Ratio (CRR)	Statutory Liquidity Ratio (SLR)
To meet cash payment requirement, banks have to maintain certain minimum ready cash balances at all times called CRR. **(Section 42).** It can be maintained; • either a cash reserve with itself or • as balance in a current account with the Reserve Bank of India or • by way of net balance in current accounts Every Scheduled Commercial Bank has to maintain cash reserve ratio.	Banking companies have to maintain sufficient liquid assets in the normal course of business. The ratio of such liquid assets to demand and time liabilities is known as Statutory Liquidity Ratio (SLR). The assets that are maintained as SLR Assets are; • Cash • Gold • SLR Securities: ➢ Dated Securities of Government of India ➢ Treasury Bills of Government of India ➢ State Development Loans of State Governments • Deposits & Securities maintained with RBI (by a banking company incorporated outside India) under the Banking Regulation Act 1949 • Surplus balance maintained with RBI under the RBI Act 1934 • Current Account net balances in other commercial banks It prevents banks from over-extending their resources
Students are advised to refer to recent pronouncements for rates applicable for CRR & SLR	

2.4 Restriction of Loans and Advances

According to **(Section 20),** no Banking company shall;

- Grant any loans or advances on the security of its own shares
- Grant any loans or advances to or on behalf of:
  - Any of its Directors
  - Any firm in which any of its Directors is interested as partner employee, manager or guarantor.
  - Any individual in respect of whom any of its Directors is a partner or guarantor.

2.5 Restriction on Acquisition of Shares in Other Company

A banking company can form any subsidiary only for;

- Any permissible business.

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- Carrying on banking business, exclusively outside India with the permission of RBI.
- Such other business considered to spread banking in India or in public interest, which the RBI approves with Central Government permission

A banking company cannot hold shares in any company either as pledge, mortgage, or absolute owner of an amount not exceeding

- **30%** of the **paid-up share capital of that company** or
- **30%** of its **own paid-up share** capital and reserves,

whichever is **less**.

2.6 Capital and Reserve

Requirements as to minimum paid up capital and reserve (Section 11)

Cases	Paid up Capital and Reserve
A) When Incorporated **outside** India :- • Having place of business in **Mumbai or Kolkata or both.** • In other cities **except** Mumbai or Kolkata. All such companies are required to deposit with Reserve bank either in cash or in the form of unencumbered approved securities, the minimum amount of paid up capital and reserve	• Rs **20 lacs or more** • Rs **15 lacs or more**
B) When Incorporated **In India** :- • Having place of business in more than one state and it has a place or places of business in **Mumbai or Kolkata** or both. • Having place of business in more than one state but **not in Mumbai or Kolkata** • Having all its place of business in one state and none of which is situated in the Mumbai or Kolkata. • Having all is places of business in one state and one or more of which is situated in city of Mumbai or Kolkata.	• Rs **10 lacs or more.** • Rs **5 lacs or more** • Rs **1 lakh** in respect of all its principal places of business plus Rs **10,000** for its other places of business situated in the same district in which it has its principal place of business plus **Rs 25000** in respect of each place of business elsewhere in the state. • Rs **5 lacs plus Rs 25,000** in respect of place of business outside Mumbai or Kolkata.
C) When the banking company has **only one place of business** and it is not Mumbai or Kolkata.	• Rs **50,000**

Regulation relating to authorized capital subscribed capital and paid up capital (Section 12)

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No banking company can carry on business in India unless it satisfies the following conditions:

i. Its **subscribed capital** shall not be less than **half of its authorised capital** and the **paid up capital** shall not be less than **half of its subscribed capital.**
ii. Its capital consists of ordinary shares only or ordinary equity shares and such preference shares as may have been issued prior to 1st April 1944.
iii. The voting right of any share holder cannot **exceed 10% of the total voting** rights.

Restriction on commission, brokerage, discount on sale of shares (Section 13)

No banking company shall pay out **directly or indirectly :**

- by way of Commission, brokerage, discount or remuneration,
- in respect of any shares issued by it,

Any amount exceeding **2.5% of the paid up value** of such shares.

3. Books of accounts, returns and forms of financial statements

A bank has a large number of customers whose accounts are to be maintained and kept **up to date** and ensured it can be checked regularly. Therefore it is very important that banks should have a proper system of book keeping.

The Main **Characteristics** of a bank's system of book-keeping are as follows:

- **Voucher posting** - Vouchers are simple leaves of journals or cash books on which transactions are recorded **as they occur**.
- **Voucher summary sheets** - The vouchers entered each day are **summarised** on summary sheets, totals of which are posted to the control accounts.
- **Daily trial balance** - The general ledger trial balance is extracted and agreed every day.
- **Continuous checks** - All entries in the ledgers and summary sheets are checked by persons other than those who have made the entries to **detect mistakes**
- **Control Accounts** - A trial balance of the detailed personal ledgers is prepared periodically, usually every two weeks, and gets agreed with general ledger accounts.
- **Double voucher system** - Two vouchers are prepared for every transaction **not involving cash:** debit voucher and another credit voucher.

Slip (Or Voucher) System Of Ledger Posting:

Under this system entries are made in the (personal) accounts of customers in the ledger **directly from various slips** (also called vouchers rather than from subsidiary books. Subsequently, entries in the accounts of the customers are tallied with the Day Book.
The types of slips used in bank book-keeping are:

- When a customer deposits money with a bank, he has to fill-up a printed **pay-in-slip** form and submit it to the 'receiving cashier' of the bank along with cash.
- When a customer withdraws money from the bank, he has to fill-up or write a **cheque or withdrawal form** and submit it to the paying cashier who makes payment,
- Sometimes the bank staff also prepares slips for which there are no original vouchers known as **dockets** like for interest due.

However due to complete **computerization** of the banking sector, pay in slips are not used in many banks.

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3.1 Books of Accounts

Books of accounts	Details
Principal Books of Accounts	In order to have proper track of voluminous transaction and internal check on the record of these transactions, banks are required to maintain Principal books of accounts • **General Ledger:** It contains accounts of all personal ledgers, the profit and loss account and different asset accounts, control over transactions which have no direct effect on the bank's position e.g., letters of credit opened. • **Profit and Loss Ledger**: Apart from one account for profit and loss in the General ledger some banks maintain separate books for detailed accounts.It provides information regarding income and operating expenses.
Subsidiary books	• **Personal Ledgers** : Banks keep separate ledgers for different types of account such as current accounts, savings accounts, Fixed Deposits accounts, Loans, Overdrafts etc. • **Bills Registers**: These record transactions pertaining to different types of bills such as Bills purchased, Bills for Collection etc. ▪ **Subsidiary Registers:** There are different registers for various types of transactions according to the individual needs of each bank. For example, there will be registers for Demand Drafts, Telegraphic Transfers and Mail Transfers issued on/from Branches and Agencies, Letters of Credit, Letters of Guarantee.
Memorandum books	Various departments of the bank have to maintain a number of memoranda books to facilitate their work. **Cash Department**: 1. Receiving cashiers cash Book 1. Paying Cashiers Cash Book 2. Main Cash Book 3. Cash Balance Book **Outward Clearing Department**: 1. Clearing Cheques Received book 2. Bank wise list of above cheques sent to the Clearing House **Loans and Overdrafts Department:** 1. Register of securities 2. Overdraft Sanction Register etc. 3. Storage Books, delivery order books 4. Drawing Power books etc. **Deposits Department:**

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	1. Account Opening & Closing registers. 2. For Fixed Deposits, Rate register giving analysis of deposits according to rates. 3. Due Date Diary. 4. Specimen signature book. **Establishment department:** 1. Salary and allied registers, such as attendance register, leave register, overtime register, etc. 2. Register of fixed assets, e.g., furnitures and fixtures, motor cars, vehicles, etc. 3. Stationery registers 4. Old records register. **General:** 1. Signature book of bank's officers. 2. Private Telegraphic Code and Cyphers.
Statistical books	Statistical records kept by different banks are in accordance with their individual needs. For example, there may be books for recording 1. average balance in loans and advances 2. deposits received and amount paid out each month in the various departments, 3. number of cheques paid etc.

3.2 Financial Reporting by Banking Companies

Reserve Bank of India has issued certain guidelines for preparation of profit and loss account and balance sheet by banking companies conducting affairs in India.
The financial statements are prepared in 18 schedules which are :-

- Form A- Balance sheet (Schedule 1- Schedule 12)
- Form B- Profit and Loss Account (Schedule 13- Schedule 16)
- Schedules forming Part of Annual Report:
  Schedule-17: Significant Accounting Policies
  Schedule-18: Notes forming part of Accounts

Notes to Accounts (Schedule-18)

In addition to the 16 schedules to their Balance Sheet, banks are required to furnish in the 'Notes to Accounts with details such as:

- Capital Adequacy Ratio; Tier I ; Tier II capital;
- Percentage of shareholding of the Government of India in the nationalised banks;
- The gross value of investments in India and outside India and the net value of investments in India and outside India;
- Provisions made towards depreciation in the value of investments and the movement of such provisions;
- Provisions of net NPAs to net advances; Provisions made towards NPAs and the movement of such provisions;

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- Maturity pattern of investment securities, loans and advances, deposits, borrowings, foreign currency assets and liabilities;
- Details of 'Provisions and Contingencies'; provisions made during the year towards income tax, standard asset, floating provisions;
- Disclosures of business ratios such as interest income as a percentage to working funds; operating profit as a percentage to working funds; return in assets; business(deposits plus advances) per employee; and profit per employee
- Lending to sensitive sectors, which are sensitive to asset price fluctuation. These should include advances to sectors such as capital market, real estate, etc.
- Disclosures relating to repo transactions; non –SLR investment; forward rate agreement; and risk exposure in derivatives.

Disclosure of Accounting Policies

For the financial position of bank to represents a true and fair view, the RBI has directed the banks to disclose the accounting policies regarding the key areas of operations along with the notes to account in their financial statements. Such additional disclosures are regarding:-

- Concentration of Deposits, Advanced Exposures and NPAs
- Sector-wise NPAs;
- Movement of NPAs;
- Overseas assets ,NPAs and Revenue;
- Off –balance sheet SPVs sponsored by banks.

4. Capital Adequacy Norms

According to recommendation of Basel Committee, a banking company is required to maintain sufficient owner's fund to absorb unexpected losses which the banking company may suffer in future. To fulfill this requirement banks have to maintain Capital Adequacy Ratio

At present the capital adequacy ratio is 9%.

Capital adequacy is the adequacy of capital resources of a bank in relation to the risks associated with its operations. RBI requires that bank should maintain a minimum capital adequacy ratio based on capital funds and risk assets.
Capital Adequacy Ratio mandates that a certain amount of deposits be kept aside whenever loan is being made. All Indian scheduled commercial banks (excluding regional rural banks) as well as foreign banks operating in India are required to maintain capital adequacy ratio (or capital to Risk Weighted Assets Ratio) which is specified by RBI from time to time.

The capital adequacy ratio is worked out as below:

$$\text{Capital Adequacy Ratio} = \frac{\text{Capital Fund} * 100}{\text{Risk Weighted Assets} + \text{Off Balance Sheet Items}}$$

*Capital Fund consists of Tier I & Tier II Capital

4.1 Capital Funds

Capital is divided into two tiers according to the characteristics/qualities of each qualifying instrument: Tier 1 and Tier 2.

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Tier I Capital (also known are core capital)	Tier II Capital
• Tier I capital consists mainly of share capital and disclosed reserves • It is a bank's highest quality capital because it is fully available to cover losses. • Provides the most permanent and readily available support to a bank against unexpected losses.	• Tier II capital consists of certain reserves and certain types of subordinated debt. • The loss absorption capacity of Tier II capital is lower than that of Tier I capital. • Tier-II capital cannot be more than Tier-I capital. • Tier I ≥ Tier II) i.e the quantum of tier II capital is limited to a maximum of 100% of tier I capital.
Elements a. Paid up Equity Share Capital b. Statutory Reserves c. Disclosed free Reserves d. Share Premium e. Non-Cumulative perpetual preference capital f. Innovative perpetual Debt Instruments. g. Capital reserves which represent surplus arising out of the sale proceeds of the assets. Less: a. intangible assets b. losses in the current period and those brought forward from previous period. c. DTA, which is an intangible asset, should be deducted from Tier I capital.	Elements a. Undisclosed Reserve b. 45% of Revaluation Reserve c. General provisions and loss reserves, 'Floating Provisions' held by bank, Investment Reserve (subject to 1.25% of risk weighted asset) d. Convertible Debentures/ Hybrid Debts e. Subordinate debts (subject to 50% of tier-I capital) f. Investment Reserve Account g. Cumulative Redeemable Preference Capital

Deductions from Tier I and Tier II Capital

- Equity/non-equity investments in subsidiaries should be deducted at 50 per cent each, from Tier I and Tier II capital of the parent bank, while assessing the capital adequacy of the bank on 'solo' basis, under the Basel I Framework.
- Credit Enhancements pertaining to Securitization of Standard Assets

4.2 Risk-Adjusted Assets

For CAR purposes the entire assets side of the Banks Balance Sheet is recalculated on the basis of assigning risk weights to each category of assets. This follows the principle of conservatism by considering assets at their Risk Adjusted Values rather than at their face value in calculating the CAR.
The RBI has assigned different risk weights to different categories of assets. For example, cash, balances with Reserve Bank of India is assigned a risk weight of zero

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The risk adjusted value for any category of assets is determined by multiplying the value of the category of an asset as per the balance sheet with the risk weight assigned thereto.

The important weights for the purpose of Ascertainment of CAR are as follows:-

Assets	Risk Weight %
1. Cash. balances with RBI	0
2. Balances in current account with other banks	20
3. Investments in Government Securities	0
4. Other Investments	100
5. Loans & Advances guaranteed by Government	0
6. Other Loans & Advances	100
7. Bank Premises, Furniture & Fittings etc.	100
8. All Off- Balance Sheet Items like LC's, LG's, Bills	100
9. Non funded exposure to Real estate	150

Reporting for Capital Adequacy Norms

Banks should furnish an annual return. The format for the returns is specified by the RBI under Capital Adequacy Norms. The returns should be signed by two officials who are authorised to sign the statutory returns now being submitted to the Reserve Bank.

5. Income Recognition, Classification of Assets and Provisions

5.1 Income Recognition

Bank's income is from mainly two sources:

1. Interest earned on Loans & Advances extended to its customers.
2. Discount and commission earned handling Bills of Exchange and Non-Funded advances like Letter of Credit (LC), Letter of Guarantee (LG) etc.

Income recognition for interest earned is based on whether such assets are Performing Assets or Non-Performing Assets.

- Performing Assets:- Any such assets that generates income on regular basis are called Performing Assets. Interest income generated from such assets is recognised on Accrual Basis.
- Non-Performing Assets (NPA):- An Asset (loans & Advances) including lease assets becomes Non-Performing Assets when they cease to generate income for banks. In most of the cases, debt is classified as non-performing when loan payments have not been made for a period of 90 days. According to prudence norms interest income on NPA's cannot be recognised on accrual basis. It can be recognised only on Cash Basis.

5.2 Identification of NPA

Type of Assets	Becomes NPA if;
Bills purchased and discounted	if interest and / or instalment of principal remain overdue for a period exceeding 90 days.
Term Loan	if their amount (interest or principal) remain overdue wholly or partly for a period exceeding 90 days.

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A cash credit / overdraft	if it becomes out of order.
Agricultural Advances	in case of short duration crops, if interest and/or installment of principal remains overdue for two crop seasons for long duration crops, if the installment of principal or interest thereon remains overdue for one crop season.
Securitisation transactions	when the amount of liquidity facility remains overdue for more than 90 days.
Derivative transactions	when the overdue receivables representing positive mark to market value of a derivative contract remain unpaid for a period of 90 days from the specified due date for payment.
Government guaranteed advances	when the Government repudiates its guarantee when invoked. For, State Government guaranteed advances and investments in State Government guaranteed securities, if interest and/or principal or any other amount due to the bank remains overdue for more than 90 days.

An account is said to be **out of order** if;

- The outstanding balance remains continuously in excess of the sanctioned limit/drawing power for a continuous period of 90 days prior to the Balance Sheet date.
- Though the outstanding balance is less than the sanctioned limit/drawing power -
    - there have been no credits for a continuous period of more than 90 days prior to the date of balance sheet; or
    - credits during the aforesaid period are not enough to cover the interest debited during the same period.
- Further any amount due to the bank under any credit facility is 'overdue' if it is not paid on the due date fixed by the bank.

5.3 Regularisation of Account by Year-end

The identification of NP is determined on the basis of day past due basis and the same is reviewed at each reporting period.
Certain other important RBI guidelines with reference to PAs are given below:

- **Temporary Deficiencies:** The classification of an asset as NPA should be based on the record of recovery. Bank should not classify an advance account as NPA merely due to the existence of some deficiencies which are temporary in nature
- **Net Worth of Borrower/Guarantor or Availability of Security:** Since income recognition is based on recoveries from an advance account, net worth of borrower/guarantor should not be taken into account for the purpose of treating an advance as NPA or otherwise.
- **Determination of NPAs:** Borrower-wise, Not Facility-wise: If any of the credit facilities granted to a borrower becomes non-performing, all the facilities granted to the borrower will have to be treated as NPA without any regard to performing status of other facilities.
- **Partial Recoveries in PAs:** Interest partly realised in NPAs can be taken to income.

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Reversal of Income Credited for the Past Period

Once any advance including bills purchased and discounted becomes NPA the entire interest accrued and credited to income account in the past periods should be **reversed** if the same is **not realised.**

5.4 Interest Suspense Account

Banking companies are allowed to recognize interest on NPA **only on cash basis**. So in final accounts we **cannot record interest accrued** on NPA in interest income account
To mark the advance with interest accrued we should open a dummy account named **Interest Suspense Account.**

JOURNAL ENTRIES

Date	Particulars	Debit (₹)	Credit(₹)
	Opening Interest Suspense Account Loans a Advances A/c Dr. To Interest Suspense A/c		
	When the bank realises the amount from the borrower towards his outstanding balance whether in full or in part, we recognise income for actual cash received in settlement Interest Suspense A/c Dr. To Interest Income A/c		
	Income will be subsequently transferred to P/L Account Interest Income A/c Dr. To Profit and Loss A/c		
	Reversal of the irrecoverable portion of interest suspense Interest Suspense A/c Dr. To Loans and Advances A/c		
	Entry for amount realised from loans and advances in final settlement Cash A/c Dr. To Loans and Advances A/c		
	Balance due on loans & advances (Irrecoverable Principal amount) will be transferred to Bad Debt A/c Bad Debt A/c Dr. To Loans and Advances A/c		

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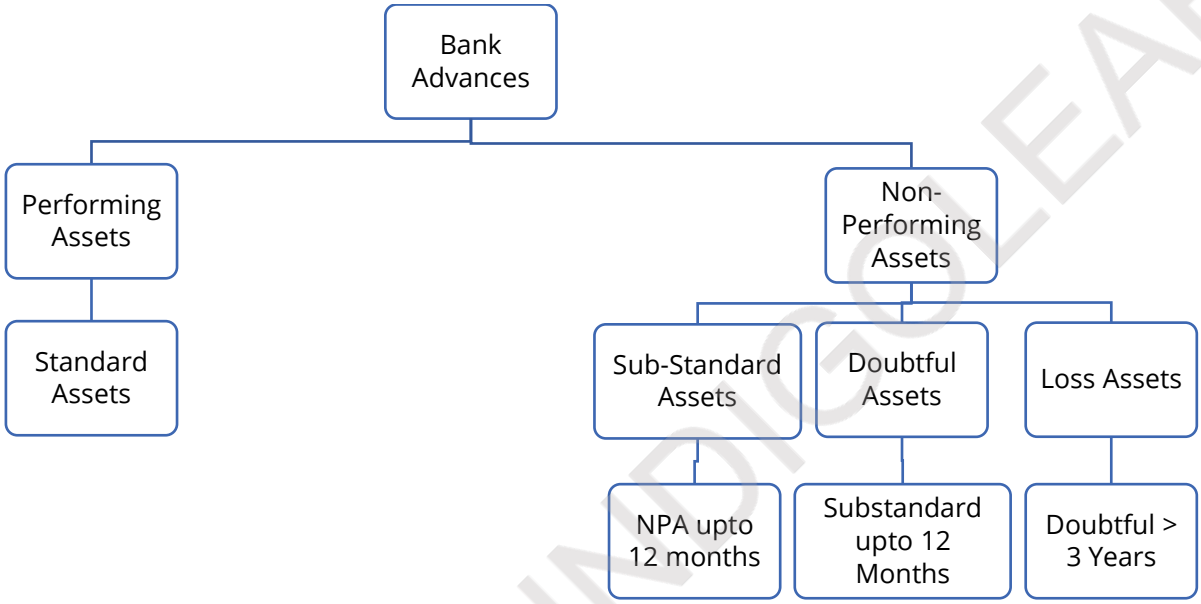
	Write off the Bad Debts against provision for NPA Provision for NPA A/c Dr. To Bad Debt A/c		

5.5 Classification of Bank Advances on Basis of Performance

The Banks have to classify their advances into two broad groups:

1. Performing Assets
2. Non-Performing Assets

Performing assets are also called as Standard Assets. The Non-Performing Assets is again classified into three groups and they are (i) sub-standard Assets (il) doubtful assets & (iii) Loss Assets.



Performing Assets (Standard Assets)

Standard Assets - Standard assets are those which does not carry more any risk than normal risk attached to the business.

Non-Performing Assets (NPA):

- **Sub-standard Assets:** A Sub-standard asset is one which has been classified as an NPA for a period not exceeding 12 months.In such cases, the bank can suffer loss if deficiencies are not corrected as the security is insufficient.
- **Doubtful Assets**: An asset would be classified as doubtful if it has remained in the substandard category for a period of at least 12 months.
- **Loss Assets**: An asset may remain doubtful asset for a period of 3 years. But as soon as any of the following 3 authorities declare an advance as irrecoverable, then it will become Loss Assets.
    - Officer of bank
    - Auditor of bank (statutory or internal)
    - Inspector of RBI during inspection.

In other words such an asset is considered uncollectible. However, only those advances are classified as loss assets where no security is available. where some security/ECGC/DICGC cover is available, these accounts are not reported under loss asset.

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Where there are potential threats to recovery on account of erosion in the value of security or non-availability of security and existence of other factors such as frauds committed by borrowers, Banks have been advised to classify such accounts straightway as doubtful or loss assets, as appropriate irrespective of the period for which the account has remained NPA.

5.6 Provisions

Taking into account the time lag between an asset becoming substandard/doubtful turning into loss asset, RBI has directed that bank should make provision against all assets (i.e) Loans & advances

Rates of Provisioning

Category of Advances	Particulars	%
Performing assets/ standard assets	direct advances to agricultural and Small and Micro Enterprises (SMEs) sectors advances to Commercial Real Estate (CRE) Sector All others	0.25 1.00 0.40
Non performing assets Sub-standard assets	Secured Unsecured: Loan given to Infrastructure companies and bank had sufficient safety measure Other Unsecured	15 20 25
Doubtful Assets	Secured Doubtful for less than or equal to 1 Year Doubtful for 1-3 Years Doubtful for more than 3 Years Unsecured	 25 40 100 100
Loss Assets	Written off	100

Provisioning for Advances covered by ECG/DICGC Guarantee

- If a loan is classified as doubtful and guaranteed by ECG (Export Credit Guarantee Corporation) or DICGC, then for such guaranteed part, bank is **not required** to create any provision for bad debts.
- In case the bank also holds a security in respect of advance guaranteed, the **realisable value of security should be deducted** from the outstanding balance before the guarantee is off set.

5.7 Classification and Valuation of Investments

The entire investment portfolio of a bank (including SLR securities and non- SLR securities) should be classified under three categories:

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HELD TO MATURITY

Securities acquired by banks with the intention to hold them upto maturity.

Only debt securities can be classified as held to maturity because they have a definite maturity.

Investments under this category should not exceed 25 per cent of the total investment.

VALUATION:
They appear on the balance sheet at the Amortized Cost. (Meaning the Initial acquisition Cost plus any additional cost incurred to date.)

HELD FOR TRADING

These are financial assets that are held with the sole intent of generating short term profits.

Such investments are held for a short period of time.

These securities are to be sold within 90 days.

VALUATION:
reported at its fair value on the balance sheet and any change in the fair value during a period and any dividend or interest income over the period is recognised in the profit or loss for the period.

AVAILABLE FOR SALE

Securities which do not fall within the above two categories should be classified as 'Available for Sale'.

The banks can decide the extent of holding under HFT and AFS based on the various aspects.

VALUATION:
Available for sales are also valued at the fair value. Any resulting gain or loss is recorded to an unrealised gain and loss account.

6. Discounting, collection & acceptance of bills

6.1 Discounting:

- A bank may straight away **purchase** a Bill. In this case after **reducing discount** charges, the **balance** amount is **credited to the account of the customer**.
- On due date the bank will **retire the bill with the customer** and get his payment.
- When someone gets a bill discounted, the bank **credits the discount account** with the full amount of the discount, the bank will earn in respect of that bill.
- Some of these bills will not mature by the close of the accounting year. The **portion of the discount** which relates to the **period falling after** the close of the accounting period is called **'rebate on bills discounted**', or 'unearned discount'.

6.2 Collection of Bills

- Banks **collect the dues** against Bills of Exchange from their customers on the due dates.
- Where the bills have been discounted, the proceeds of such bills on due date are treated as **incomes** of the bank.
- Where the bills have not been discounted, the proceeds on maturity are credited to the account of the customer.
- Two Accounts have to be opened: Bills for Collection (Asset) and Bills for Collection (Liability)

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6.3 Acceptance and Endorsement

- The bank is often called to accept or endorse a bill on behalf of its customers.
- The bank has to honour this acceptance on behalf of its client **only in the event of a client failing to honour** the bill on the due date.
- The bank has a corresponding **claim against the customer** on whose behalf it has undertaken to be a party to the bill.
- Such Acceptance (Liabilities) which are outstanding at the close of the year and the corresponding asset (security) is disclosed as **Contingent liability.**

7. Summary

Banks in India and their activities are regulated by the **Banking Regulation Act, 1949**.
A bank maintains a large number of accounts of various types for its customers.

Every bank should maintain a minimum **capital adequacy ratio** based on capital funds and risk assets.

Capital is divided into two tiers:

- **Tier I capital** consists mainly of share capital and disclosed reserves and it is a bank's highest quality capital because it is fully available to cover losses.
- **Tier II capital** on the other hand consists of certain reserves and certain types of subordinated debt.

The **risk adjusted value** for any category of assets is determined by multiplying the value of the category of an asset as per the balance sheet with the risk weight assigned thereto.

Rates of Provisioning

Category of Advances	Particulars	%
Performing assets/ standard assets	direct advances to agricultural and Small and Micro Enterprises (SMEs) sectors advances to Commercial Real Estate (CRE) Sector All others	0.25 1.00 0.40
Non performing assets Sub-standard assets	Secured Unsecured: Loan given to Infrastructure companies and bank had sufficient safety measure Other Unsecured	15 20 25
Doubtful Assets	Secured Doubtful for less than or equal to 1 Year Doubtful for 1-3 Years Doubtful for more than 3 Years Unsecured	 25 40 100 100
Loss Assets	Written off	100

Bank also performs functions such as **Discounting of bills; Collection of bills; Acceptances and Endorsement on behalf of customers.**

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1. Illustration

A commercial bank has the following capital funds and assets. Segregate the capital funds into Tier I and Tier II capitals. Find out the risk-adjusted asset and risk weighted assets ratio:

Capital Funds:	Rs. Lakh
Equity Share Capital	4,80,00
Statutory Reserve	2,80,00
Capital Reserve (of which ₹ 280 lakhs were due to revaluation of assets and the balance due to sale)	12,10
Assets:	
Cash Balance with RBI	4,80
Balances with other Bank	12,50
Claims on Banks	28,50
Other Investments	782,50
Loans and Advances:	
i. Guaranteed by government	128,20
ii. Guaranteed by public sector undertakings of Government of India	702,10
iii. Others	52,02,50
Premises, furniture and fixtures	182,00
Other Assets	201,20
Off-Balance Sheet Items:	
Acceptances, endorsements and letters of credit	37,02,50

Solution 1

A) Calculation of Tier-1 & Tier- II Capital

Particulars	**Tier – I (₹ in lakhs)**	**Tier – II (₹ in lakhs)**
Equity share capital	48,000	-
Statutory Reserves	28,000	-
Capital Reserves (1,210 – 280)	930	-
Revaluation Reserve (45% of 280)	-	126
Total	**76,930**	**126**

B) Calculation of Risk Adjusted Assets

Particulars	**Amount (₹ in lakhs)**	**Risk (%)**	**Risk (₹) (₹ in lakhs)**
Cash Balance with RBI	480	0	0
Balance with other Banks	12,50	20	250
Claims on Banks	28,50	20	570
Other Investments	7,82,50	100	7,82,50

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Loans and Advances Guaranteed by Govt.	1,28,20	0	0
Loans and Advances Guaranteed by Public Sector	7,02,10	0	0
Loans and Advances Others	52,02,50	100	52,02,50
Premises, Furniture & Fixtures	1,82,00	100	1,82,00
Other Assets	2,01,20	100	2,01,20
			63,76,40
Off- B/s Items : Acceptances, endorsements and LoC	37,02,50	100	250
Total			**1,00,78,90**

2. Illustration

The outstanding amount (funded as well as unfunded) as on 31st March 2011 was ₹10,000. The realizable value of security of the same was ₹8,000. Period for which the advance has remained in 'doubtful' category as on 31st March 2011 was: 2.5 years.

Compute the total provision required for year ended 31st March 2011 and 31st March 2012 as per relevant banking provisions.

Solution 2

	Asset Classification		**Provisions on secured portion**		**Provisions on unsecured portion**	**Total (₹)**
		%	**Amount**	**%**	**Amount**	
	Doubtful 1 to 3 years	40	3,200	100	2,000	**5,200**
	Doubtful more than 3 years	100	8,000	100	2,000	**10,000**

3. Illustration

From the following information, find out the amount of provisions to be shown in the Profit and Loss Account of AG bank.

Assets		**₹In lakhs**
Standard		5,000
Sub-standard		4,000
Doubtful	: for one year	800
	: for three years	600
	: for more than three years	200
Loss Assets		1,000

Solution 3

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Assets	Amount in Lakhs	% Provision	Provision in Lakhs
Standard	50,00	0.4	20
Substandard (Assumed to be secured exposure)	40,00	15	600
Doubtful for one year (D1) (Assumed to be secured)	8,00	25	200
Doubtful for three year (D2) (Assumed to be secured)	6,00	40	240
Doubtful for more than three years (D3) (Assumed to be secured)	2,00	100	200
Loss	10,00	100	1,000
Total Provision required			**2,260**

Exam Tip: if the question silent about secured and unsecured portion of the loan of Doubtful Debts, then assume it to be secured.

4. Illustration

From the following information of AY Limited, compute the provisions to be made in the Profit and Loss account:

	₹ In lakhs
Assets	
Standard	20,000
Sub-standard	16,000
Doubtful	
For one year (secured)	6,000
For two years and three years (secured)	4,000
For more than three years (secured by mortgage of plant and machinery ₹600 lakhs)	2,000
Loss Assets	1,500

Solution 4

Calculation of amount of provision to be made in the Profit and loss A/c

Classification of Assets	Amount in Advances	% age of Provision	Amount of Provision
	(₹ in lakhs)		(₹ in lakhs)
Standard assets	20,000	0.4	80
Sub-standard assets	16,000	15	2,400
Doubtful assets :			
• For one year (secured)	6,000	40	1,600
• For two year (secured)	4,000	100	1,400
• For more than three years	1,400	100	600
(unsecured) D3	600	100	1,500
(secured)			

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Non- recoverable assets (Loss assets)	1,500	100	1,500
Total provision required			**9,080**

5. Illustration

From the following information, compute the amount of provision as per applicable banking provisions:

Outstanding Balance	₹ 4 lakhs
ECGC Cover	50%
Period for which the advance has remained doubtful	More than 3 years remained doubtful (as on March 31, 2011)
Value of security held	₹1.50 lakhs

Solution 5

(A)

Sr.no	Particulars	Amount (₹ in lakhs)	% of Provision	Amount (₹ in lakhs)
1	Advance balance	4.00		
2	Less: secured (D – III)	(1.50)	100	1.50
3	Unsecured (1) – (2)	**2.50**		
4	ECGC guarantee 50% of (3)	(1.25)	0	-
5	Unsecured portion for provision (D – III)	**1.25**	100	1.25
Total Provision required				**2.75**

(B)

Sr.no	Particulars	Amount (₹ in lakhs)	% of Provision	Amount (₹ in lakhs)
1	Advance balance	4.00		
2	Less: secured (D – III)	(1.20)	100	1.20
3	Unsecured (1) – (2)	**2.80**		
4	ECGC guarantee 50% of (3)	(1.40)	0	-
5	Unsecured portion for provision (D – III)	**1.40**	100	1.40
Total Provision required				**2.60**

6. Illustration

In KR Bank, the doubtful assets (more than 3 years) as on 31.3.2011 is ₹ 1,000 lakhs. The value of security (including DICGC 100% cover of ₹100 lakhs) is ascertained at ₹500 lakhs. How much provision must be made in the books of the Bank towards doubtful assets?

Solution 6

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Sr.no	Particulars	Amount (₹ in lakhs)	% of Provision	Amount of provision (₹ in lakhs)
1	Advance balance	1,000		
2	Less: secured (D – III)	(400)	100	400
3	Unsecured (1) – (2)	**600**		
4	ECGC guarantee 50% of (3)	(100)	0	-
5	Unsecured portion for provision (D – III)	**500**	100	500
		Total Provision required		**900**

7. Illustration

A loan outstanding of ₹50,00,000 has DICGC cover. The loan guaranteed by ICGC is assigned a risk weight of 50%. What is the value of Risk-adjusted asset?

Solution 7

Particulars	(₹)
Loan outstanding	50,00,000
Guaranteed by DICGC – Risk weight	50%
Value of risk adjusted asset ₹ 50,00,000 x 50%	25,00,000

8. Illustration

The following is an extract from Trial Balance of overseas Bank as at 31st March, 2011:

	₹	₹
Bills discounted	12,64,000	
Rebate on bills discounted not dueon March 31st, 20X0		22,160
Discount received		1,05,708

An analysis of the bills discounted is as follows:

	Amount ₹	Due Date 2011	Rate of Discount (%)
(i)	1, 40,000	June 5	14
(ii)	4, 36,000	June 12	14
(iii)	2, 82,000	June 25	14
(iv)	4, 06,000	July 6	16

Calculate Rebate on Bills Discounted as on 31-3-2011 and show necessary journalentries.

Solution 8

An Analysis of the bills discounted is as follows

Amount	Days	Discount	Amount
1,40,000	30 + 31 + 5 = 66	14%	3,544
4,36,000	30 + 31 + 12 = 73	14%	12,208
2,82,000	30 + 31 + 25 = 86	14%	9,302
4,06,000	30 + 31 + 30 + 6 = 97	16%	17,263
		Total	**42,317**

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The amount of discount to be credited to the Profit and loss A/c will be

Particulars	**Amount**
Discount received during the year ended 31.3.2011	1,05,708
Less: Closing Rebate	(42,317)
Add: Opening Rebate	22,160
Discount amount of P&L	**85,551**

Rebate on Bills discounted A/c (Liability A/c)

Particulars	**₹**	**Particulars**	**₹**
To Discount on bills A/c	22,160	By balance b/d	22,160
To balance c/d	42,317	By Discount on bills A/c	42,317

Discount on Bills A/c (Liability A/c)

Particulars	**₹**	**Particulars**	**₹**
To Rebate on bills A/c	42,317	By Discount on bills	22,160
To P & L A/c	85,551	By Bank A/c	1,05,708

Journal entries

Date	**Particulars**	**Dr ₹**	**Cr ₹**
1)	Rebate on bills discounted A/c Dr To Discount on Bills A/c (Being the transfer of Rebate on Bills Discounted on 31-03-2010 to Discount on Bills Account	22,160	22,160
2)	Bank A/c Dr To Discount on Bills A/c (Being discount received during the year)	1,05,708	1,05,708
3)	Discount on Bills A/c Dr To Rebate on Bills Discounted A/c (Being the transfer of rebate on bills discounted required on 31-3-2010 from discount on Bills Discount)	42,317	42,317
4)	Discount on Bills A/c Dr To Profit and Loss A/c (Being the amount of discount on bills transferred to P&L A/c)	85,551	85,551

9. Illustration

On 31st March, 2011, Uncertain Bank had a balance of ₹ 9 crores in "rebate on bills discounted" account. During the year ended 31st March, 2012, Uncertain Bank discounted bills of exchange of ₹4,000 crores charging interest at 18% per annum the average period of discount being for 73 days.

Of these, bills of exchange of ₹600 crores were due for realisation from the acceptors/customers after 31st March, 2012, the average period outstanding after 31st March, 2012 being 36.5 days.

Uncertain Bank asks you to pass journal entries and show the ledger accounts pertaining to:

(i) discounting of bills of exchange and

(ii) rebate on bills discounted.

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Solution 9

Rebate A/c

Particulars	₹(Crores)	Particulars	₹(Crores)
To Discount A/c	9.00	By Balance b/d	9.00
To Balance c/d	10.8	By Discount A/c	10.8
	19.8		19.8

Discount A/c

Particulars	₹ (Crores)	Particulars	₹(Crores)
To Rebate A/c	10.8	By Rebate A/c	9.00
To P & L A/c	142.2	By Clients A/c	144
	153.00		153.00

Journal entries

Date	Particulars	Dr ₹ (Crores)	Cr ₹ (Crores)
1)	Rebate on bills discounted A/c Dr To Discount on Bills A/c (Being the transfer of opening balance in Rebate on Bills Discounted to Discount on Bills Account)	9.00	9.00
2)	Client / Bank A/c Dr To Discount on Bills A/c (Being income received)	144	144
3)	Discount on Bills A/c Dr To Rebate on Bills Discounted A/c (Being Provision made)	10.80	10.80
4)	Discount on Bills A/c Dr To Profit and Loss A/c (Being the amount of income for the year from discounting of bill exchange transferred to P & L A/c)	142.20	142.20

10. Illustration

The following information is available in the books of X Bank Limited as on 31st March, 2012:

	₹
Bills discounted	1,37,05,000
Rebate on Bills discounted (as on 1.4.2011)	2,21,600
Discount received	10,56,650

Details of bills discounted are as follows:

Value of bill (₹)	Due date	Rate ofDiscount
18,25,000	5.6.2012	12%
50,00,000	12.6.2012	12%
28,20,000	25.6.2012	14%
40,60,000	6.7.2012	16%

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Calculate the rebate on bills discounted as on31.3.2012 and give necessary journal entries.

Solution 10

Journal entries

Date	Particulars		Dr ₹	Cr ₹
1)	Rebate on bills discounted A/c To Discount on Bills A/c (Being the transfer of opening balance in Rebate on Bills Discounted to Discount on Bills Account)	Dr	2,21,600	 2,21,600
2)	Customer A/c To Discount on Bills A/c (Being income for the current year recognised)	Dr	10,56,650	 10,56,650
3)	Discount on Bills A/c To Rebate on Bills Discounted A/c (Being provision made on 31st march ,2012)	Dr	10.80	 10.80
4)	Discount on Bills A/c To Profit and Loss A/c (Being transfer of discount on bills ,of the year, to profit and loss A/c)	Dr	142.20	 142.20

11. Illustration

On 1-4-2011 Bills for collection were Rs.7, 00,000. During 2011-2012 bills received for collection amounted to Rs.64, 50,000, bills collected were Rs.47, 00,000 and bills dishonoured and returned were Rs.5, 50,500. Prepare Bills for Collection (Assets) A/c and bills for Collection (Liability) A/C.

Solution 11

Bills for Collection Asset A/c

Particulars	₹(lakhs)	Particulars	₹(lakhs)
To Balance b/d	7.00	By Bills for collection liability A/c	47.00
To Bills for collection liability A/c	64.50	By Bills for collection liability A/c	5.50
		By Balance c/d	19.00
	71.50		**71.50**

Bills for Collection Liability A/c

Particulars	₹(lakhs)	Particulars	₹(lakhs)
To Bills for collection asset A/c	47.00	To Balance b/d	7.00
To Bills for collection asset A/c	5.50	To Bills for collection asset A/c	64.50
To Balance b/d	19.00		
	71.50		**71.50**

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12. Illustration

Following facts have been taken out from the records of Adarsha Bank in respect of the year ending March 31, 2012:

a. On 1-4-2011 Bills for collection were Rs.7, 00,000. During 2011-2012 bills received for collection amounted to Rs.64, 50,000, bills collected were Rs.47, 00,000 and bills dishonoured and returned were Rs.5, 50,500. Prepare Bills for Collection (Assets) A/c and bills for Collection (Liability) A/C.

b. On 1-4-2011, Acceptance, Endorsement, etc. not yet satisfied amounted to Rs.14, 50,000. During the year under question, Acceptances, Endorsements, Guarantees etc., amounted to Rs.44, 00,000. Bank honoured acceptances to the extent of Rs.25, 00,000 and client paid off Rs.10, 00,000 against the guaranteed liability. Clients failed to pay Rs.1, 00,000 which the Bank had to pay. Prepare the "Acceptances, Endorsements and other Obligations A/c" as it would appear in the General ledger.

c. It is found from the books, that a loan of Rs. 6, 00,000 was advanced on 30- 9-2011 @ 10 per cent p.a. interest payable half yearly; but the loan was outstanding as on 31-3-2012 without any payment recorded in the meantime, either towards principal or towards interest. The security for the loan was 10,000 fully paid shares of Rs. 100 each (the market value was Rs. 98 as per the Stock Exchange information as on 30th Sept., 2011). But due to fluctuations, the price fell to Rs.40 per share in January, 2012. On 31-3-2012, the price as per Stock Exchange rate was Rs.82 per share. State how you would classify the loan as secured/unsecured in the Balance Sheet of the Company.

Solution 12

Acceptances, Endorsements and other obligations A/c

Particulars	₹	Particulars	₹
To Constuents Ledger A/c	25.00	By Balance b/d	14.5
To Constuents Ledger A/c	10.00	By Constuents Ledger	44.0
To Constuents Ledger A/c	1.0		
To Balance b/d	22.50		
	58.5		**58.5**

13. Illustration

From the following information, prepare a Balance Sheet of ADT International Bank as on 31st March, 2011 giving the relevant schedules and also specify at least four important Principal Accounting Polices:

Rs. In lakhs

Particulars	Dr	Cr
Share Capital		198.00
19,80,000 Shares of Rs. 10 each		
Statutory Reserve		231.00
Net Profit before Appropriation		150.00
Profit and Loss Account		412.00
Fixed Deposit Account		517.00
Savings Deposit Account		450.00
Current Accounts	28.00	520.12
Bills Payable		0.10
Cash credits	812.10	
Borrowings from other Banks		110.00
Cash in Hand	160.15	

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Cash with RBI	37.88	
Cash with other Banks	155.87	
Money at Call	210.12	
Gold	55.23	
Government Securities	110.17	
Premises	155.70	
Furniture	70.12	
Term Loan	792.88	
Total	**2,588.22**	**2,588.22**

Additional Information:

Bills for collection	18,10,000
Acceptances and endorsements	14,12,000
Claims against the Bank not acknowledgedas debt	55,000
Depreciation charges—Premises	1,10,000
Furniture	78,000

50% of the Term Loans are secured by Government guarantees. 10% of cash credit is unsecured

Solution 13

Balance sheet of ADT International Bank As on 31st March, 2011

Capital and liabilities	**Schedule No.**	**As on 31.3.11**
Share Capital	1	198.00
Reserves and Surplus	2	793.00
Deposits	3	1487.00
Borrowings	4	110.00
Other liabilities and provisions	5	0.10
Total		**2588.22**
Assets		
Cash and balances with RBI	6	219.63
Balances with banks & money at call and short notice	7	344.39
Investments	8	165.40
Advances	9	1632.98
Fixed Assets	10	225.82
Other Assets	11	-
Total		**2588.22**
Contingent liabilities	12	14.67
Bills for collection		18.10

Schedule 1 – Capital

(Rs. Lakhs)

Authorised Capital	–
Issued, Subscribed and paid up Capital	
19,80,000 shares of Rs. 10 each	198.00

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Schedule 2 – Reserves & Surplus

	(Rs. Lakhs)	
1) Statutory Reserve		
Opening balance	231.00	
Less : Current year appropriation	37.50	
Closing balance		268.50
		524.50
2) Profit and Loss [WN: 1]		
		793.00

Schedule 3 – Deposits

(i)	Demand deposits from others	520.12
(ii)	Savings bank deposits	450.00
(iii)	Fixed deposits	517.00
		1487.12

Schedule 4 - Borrowings

Borrowings in India – Other Banks	110.00

Schedule 5 - Borrowings

Bills payable	0.10

Schedule 6 – Cash and balances with RBI

(i)	Cash in hand	160.15
(ii)	Balances with RBI in current account **[WN: 2]**	59.48
		219.63

Schedule 7 – Balances with banks and money at call and short notice

1.	In India	
	(i) Balances with banks	134.27
	(a) In current accounts (WN: 3)	
	(ii) Money at call and short notices	210.12
		344.39

Schedule 8 – Investments

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(i)	Investments in India in	
	(i) Government securities	110.17
	(ii) Others – Gold	55.23
		165.40

Schedule 9 - Advances

(A)	**Nature**	
	• Cash, Credit Overdraft Current A/c (W.Cap) [812.10 + 28]	840.10
	• Term Loans	792.88
		1632.98
(B)	**Security**	
	• Secured by tangible asset (Bal.fig)	1155.33
	• Secured by Bank/Govt guarantee (792.88x50%)	396.44
	• Others (812.10 x 10%)	81.21
		1632.98

Schedule 10 – Fixed assets

	Premises:	
	• Cost	156.80
	Less: Depreciation	(1.10)
	1)	**155.70**
	Other Fixed Assets	
	Furniture:	70.90
	• Cost	(0.78)
	Less: Depreciation **2)**	**70.12**
	(1) + (2)	225.82

Working notes:

1) Balance in Profit and Loss A/c

Profit and Loss Account (Opening balance)	412
Add: Net profit before appropriation (Profit for the year)	150
Less: Transfer to statutory reserves (25% of 150.00)	112.5
(37.5)	
Closing P & L	524.50

2)

Cash Reserve Ratio

⇨ ≥ 4% of deposits should be maintained as balance with RBI

A) 4% of 1487.12 –> 59.48

B) Current balance –> (37.88)

21.60

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⇨ Balance with other bank –> 155.87
Less: Tr. to RBI current A/c–> 21.60
Revised Bal with other banks=**134.27**

3)

Statutory Liquidity Ratio

➢ Cash on hand	160.15
➢ Bal. with other bank	134.27
➢ Money at call & short notice	210.12
➢ Gold	55.23
➢ Unencumbered government securities	110.17
	669.94

⇨ 18% Deposits 1487.12 –> 267.68
⇨ Minimum liquid assets for SLR compliances –> 267.68
⇨ Actual Liquid assets –> 669.94

➔ SLR Norms Satisfied

14. Illustration

From the following information, prepare Profit and Loss A/c of KC Bank for the year ended 31st March, 2011

Items	Rs in '000
Interest on cash credit	18,20
Interest on overdraft	7,50
Interest on term loans	15,40
Income on investments	8,40
Interest on balance with RBI	1,50
Commission on remittances and transfer	75
Commission on letters of credit	1,18
Commission on government business	82
Profit on sale of land and building	27
Loss on exchange transactions	52
Interest paid on deposit	27,20
Auditors' fees and allowances	1,20
Directors' fees and allowances	2,50
Advertisements	1,80
Salaries, allowances and bonus to employees	12,40
Payment to Provident Fund	2,80
Printing and stationery	1,40
Repairs and maintenance	50
Postage, telegrams, telephones	80

Other Information

(i) Interest on NPA's is as follows

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Rs. In '000

	Earned	Collected
Cash Credit	8,20	4,00
Over Draft	4,50	1,00
Term Loans	7,50	2,50

(ii) Classification of NPAs

	Rs. in '000s
Standard	30,00
Sub-Standard	11,20
Doubtful assets not coveredby security	2,00
Doubtful assets covered bysecurity for 1 year	50
Loss Assets	2,00

(iii) Investments Rs 27, 50,000. Bank should not keep more than 25% of investment as 'held-for-maturity' investment. The market value of rest 75% investment is Rs. 19,75,000 as on 31-3-2011

Solution 14

KC Bank

P & L Account for the year ended 31-03-13

(₹ '000)

	Particulars	Sch No.	Year ended 31-03-13
I	**Income**		
	Interest Earned	**13**	38,30
	Other Income	**14**	2,50
	Total		**40,80**
	Expenditure		
II	Interest Expended	**15**	27,20
	Operating Expenses	**16**	23,40
	Provisions and contingencies		6,80
	Total		**57,40**
	Profit and Loss		
	Net Profit / Loss for the year		(16,60)
	Profit / loss (B/f)		0
	Total		**(16,60)**
	Appropriation		**0**

Schedule -13: Interest Earned

	Particulars	₹ '000 (2012-13)	
I	Interest/ discount on advances/bills • Interest on cash credit	14,00	

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	(18,20-8,20+400)		
	• Interest on overdraft (7,50- 4,50 + 2,50)	4,00	
	• Interest on term loans (15,40 – 7,50 + 2,50)	10,40	28,40
II	Income on term loans		8,40
III	Interest on Balance with RBI		1,50
	Total		**38,30**

Schedule -14: Other Income

	Particulars	**₹ '000 (2012-13)**	
I	Commission, Exchange and Brokerage		
	• Commission on remittance and transfer	75	
		1,18	
	• Commission on letter of credit	82	2,75
II	• Commission on Govt. business		27
III	Profit on sale of Land & Building		(52)
	Loss on Exchange Transaction		
	Total		**2,50**

Schedule -15: Interest expended

	Particulars	**₹ '000**
	Interest on Deposits	27,20

Schedule -16: Operating expenses

	Particulars	**₹ '000 (2012-13)**	
I	Payment and provision for employees		
	Salaries, allowances and bonus	12,40	
	Provident Fund Contribution	2,80	15,20
II	Printing and Stationery		1,40
III	Advertisement and publicity		1,80
IV	Director's fees, allowances and expenses		2,50
V	Auditors fees and expenses		1,20
VI	Postages, telegrams, telephones etc.,		80
VII	Repair and maintenance		50
	Total		**23,40**

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Working Note:
Provision and contingencies

	Provision for NPA	**₹ '000**	
	Standard	3,000 x 0.40%	12
	Sub-standard	1,120 x 15%	1,68
	Doubtful not covered by security	200 x 100%	2,00
	Doubtful covered by security for 1 year	50 x 25%	12.5
	Loss assets	200 x 100%	2,00
			592.50
	Depreciation on current investments		
	Cost (75% of 27,50)	2,062.50	
	Less: Market value	(1,975.00)	87.50
	Total		680.00

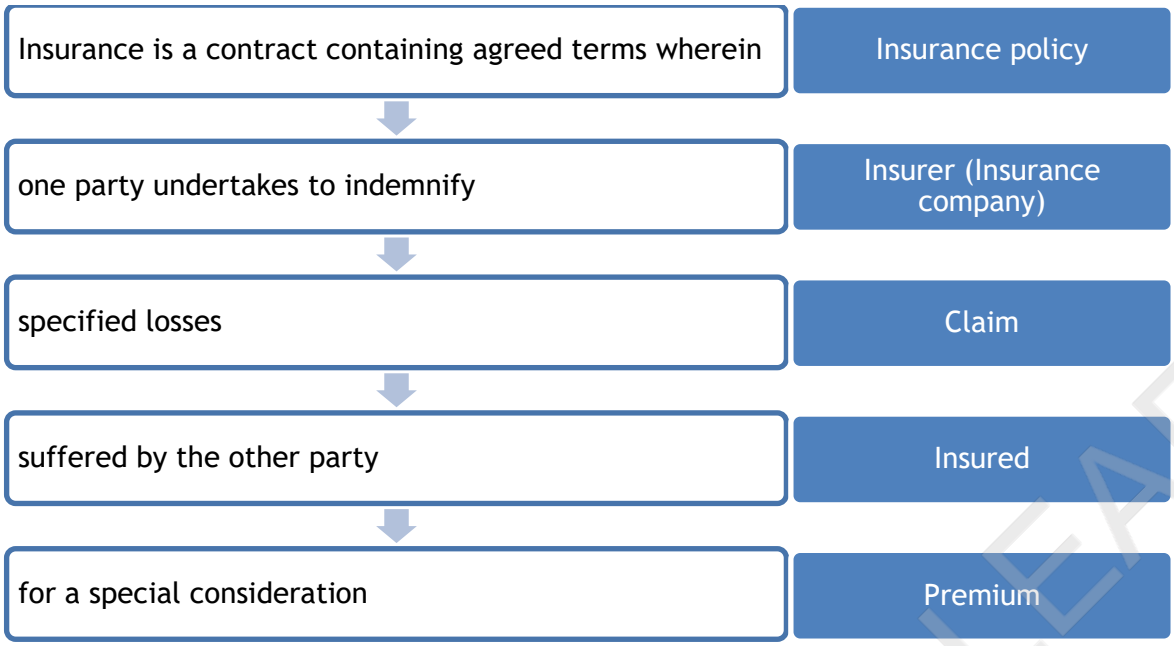
Note:

1) Sub-standard assets is assumed to be fully secured
2) Investment which are **"held to maturity"** are generally carried **at cost.** Investment which are **"held for trading"** or **"available for sale"** will be valued at **lower of cost or MV.**

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UNIT 2 - INSURANCE COMPANIES

A. Overview of the concept:



Two major types (references in definitions below) are:

- ✓ Life insurance
- ✓ General insurance (fire, marine, other miscellaneous)

B. Key terms used in insurance business:

1. Insurance policy

- ✓ The document issued by the insurance company containing terms of insurance contract.
- ✓ Specifies the losses that are covered and also the maximum amount payable (known as the policy amount).

2. Premium

- ✓ Payment made by the insured to the insurance company as a consideration for undertaking to indemnify specified losses suffered by the insured
- ✓ Is generally paid annually (maybe at shorter intervals too)
- ✓ Is to be paid front end i.e. before commencement of the insurance policy

3. Claim

- ✓ Liability that occurs when a policy falls due for payment i.e. on death or maturity of policy in case of life insurance, and on incurring of loss in case of general insurance
- ✓ A separate claims account is prepared by insurance company. At year end, the insurance company must provide for both claims intimated but not accepted, as well as claims accepted but not paid (since a year end provision, it is reversed on 1st day of next year)

4. Surrender value

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- ✓ Amount becoming due when the policy holder surrenders his right under the policy (in order to realize the amount of policy) before expiry of full term of the policy
- ✓ Calculated basis a fixed formula

5. Commission

- ✓ Represents amount paid to agents who generate business for the insurance company
- ✓ Is usually paid on the basis of insurance premium generated by the agent

6. Bonus

- ✓ Applicable to life insurance only
- ✓ Life insurance policy may be "without profits" or "with profits"

On maturity, holder is entitled to receive ONLY the amount specified in the policy	On maturity, in addition to specified amounts, holder is entitled to receive bonuses declared on each valuation

- ✓ Primarily represents excess of credit balance in Life Fund over net liability.
- ✓ Is determined by actuary on each valuation, and distributed as bonus on maturity or alternatively, in cash on declaration or as reduction of future premiums
- ✓ Reversionary bonus – when paid at the time of claim
- ✓ Interim bonus – when paid intermittently to a policyholder, before completion of valuation, without exact profit/bonus having being determined

7. Reinsurance

- ✓ Insurance taken by an insurance company to reinsure a part/whole of risk assumed by it
- ✓ Such insurance company giving up its business / risk - Ceding company
- ✓ Second insurance company assuming the risk - Reinsurer
- ✓ Ceding company shares premium it has received to cover the risk, with Reinsurer
- ✓ Reinsurer pays commission to Ceding company for providing business (income for Ceding company and expense for Reinsurer)
- ✓ Where claim arises, it is shared in pre-agreed proportions

Reinsurance business transaction is an agreement between Ceding Company and Reinsurer wherein former agrees to give up and latter agrees to take up certain specified share of risk in return for a share of premium

8. Co-insurance

- ✓ Sharing of business in case of large risks
- ✓ Shared between more than one insurers under co-insurance arrangements at agreed percentages
- ✓ Leading insurer issues documents, collects premium and settles claims, and shares Statement of Accounts with this information with other co-insurers

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9. Paid up policy

- ✓ Applicable only to life insurance
- ✓ Where holder is unable to pay future premiums, he may request for conversion into paid up policy
- ✓ Insured amount is then reduced proportionately basis the premiums paid, i.e.

  Paid up value = $\frac{\text{Sum assured}}{\text{Total Number of premium payable}}$ X Number of Premium paid

10. Annuity

- ✓ A contract that provides for an income for a specific period of time (X number of years or life)
- ✓ Such annuity payments could be monthly, quarterly, half yearly or yearly
- ✓ Person receiving the payment is called annuitant

11. Catastrophic loss

- ✓ Loss which is unbearable i.e. causes severe consequences like bankruptcy to family, organization or insured

12. Bonus in reduction of premium

- ✓ Applicable to general insurance
- ✓ General insurance policies are usually taken for one year, after which they expire and need to be renewed
- ✓ In case of renewal, insurance company usually grants certain reduction in premium if no claim was made by the insured in the preceding year
- ✓ Such reduction is called bonus in reduction of premium
- ✓ The rate of reduction increases if no claim is made year after year
- ✓ For an insurance company, it is an expense and is accounted as:

  Bonus in reduction of premium account Dr.

  To Premium account

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KEY INSURANCE PRINCIPLES:

Insurable Interest

Having a vested interest in the contract

- Insurance contracts cannot be entered into by anyone
- Every policy insists upon insurable interest
- E.g. A can insure life of B if B is his spouse, debtor, business manager etc., and NOT if B is a total stranger
- A contract without insurable interest = wagering contract

Principle of Indemnity

To compensate for losses suffered

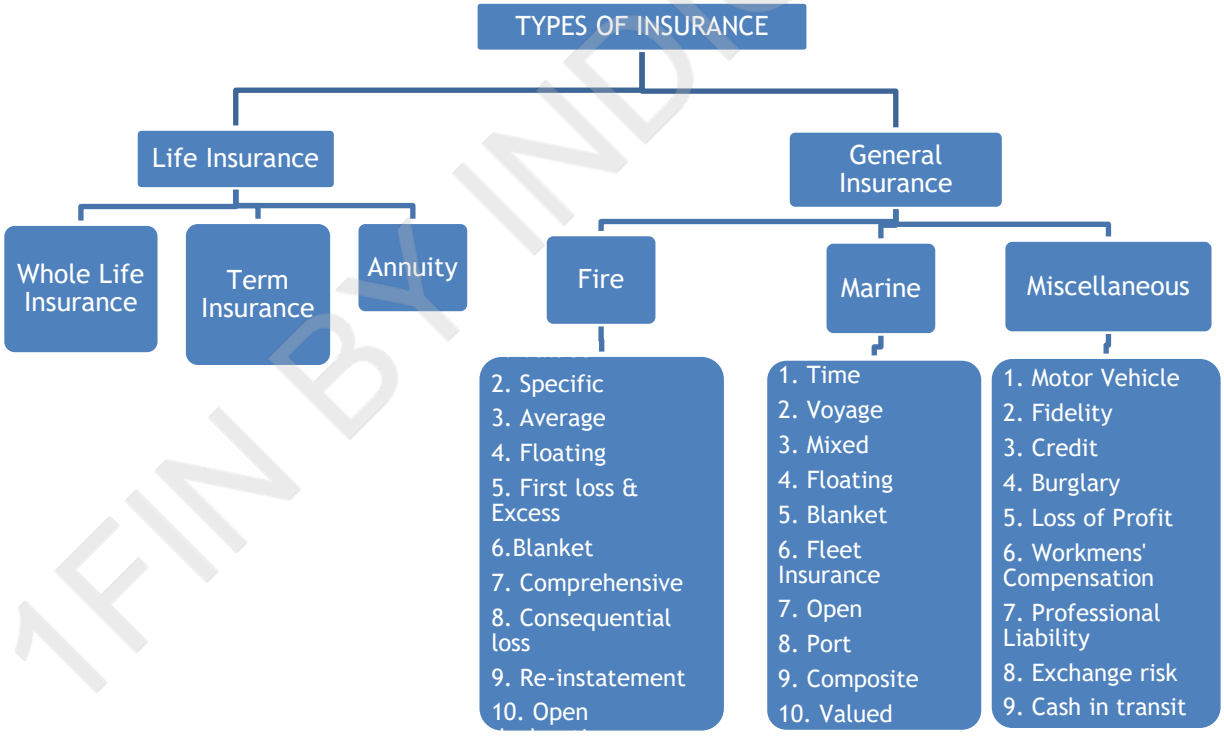
- Insurance contract is a contract of indemnity
- Insurer indemnifies the insured for loss incurred
- One cannot make profit by insuring his risks

Principle of *uberrimae fidei*

Uberrimae Fidei means utmost good faith

- Under ordinary law, there is no positive duty to tell whole truth. Only a negative obligation to tell nothing but the truth
- Insurance contract is however a contract of uberrima fidei - contract of utmost good faith
- There must be full and frank disclosure of all material facts. Assessment of risk and determination of premium depends upon the same

TYPES OF INSURANCE:



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FINANCIAL STATEMENTS OF AN INSURANCE COMPANY:

IRDA Regulations 2002 provide forms in which financial statements of an insurance company need to be prepared:

- ✓ Schedule A of Regulations prescribes formats for Life Insurance Company
- ✓ Schedule B of Regulations prescribes formats for General Insurance Company

Both Schedules provide formats for:

- ✓ Revenue Account / Policyholders' Account / Technical Account
- ✓ Profit and Loss Account / Shareholders' account / Non-technical Account
- ✓ Balance Sheet

Format for cash flow statement is not prescribed. Receipts and Payments Account to be prepared in accordance with AS 3.

APPROACH TO PROBLEM SOLVING IN EXAMS:

Revenue Account of Insurance co ~ Trading Account of any co

- ✓ [illegible] commission expenses, claims paid etc.
- ✓ Balance is transferred to P/L A/c and other requisite reserves, if any (e.g. catastrophe reserve in case of general insurance company)

Profit and Loss Account of Insurance co ~ P/L Account of any co

- ✓ Further adjusts other incomes and expenses to profit/loss determined in Revenue Account, to arrive at PBT
- ✓ Provision for tax is created
- ✓ PAT so determined, is appropriated towards dividend and other requisite reserves, if any
- ✓ Remaining balance, together with opening balance, is carried forward to Balance Sheet

Balance Sheet of Insurance co ~ Balance sheet of any co

- ✓ Like in any other balance sheet, it captures sources of funds (liabilities side) and application of funds (assets side)
- ✓ Schedules thereto capture appropriate disclosures in accordance with the regulations

Further, formats for both life insurance and general insurance are broadly similar, except some peculiarities of each business that may have to be captured additionally viz. linked business disclosures in life insurance, catastrophe reserve in general insurance.

1. Questions usually provide a host of information around expenses like commission or claims paid/payable, incomes like premium or reinsurance claims received / receivable and may ask to:
   a. Compute charge towards Reserve for Unexpired risk (general insurance business)
   b. Compute premium income as will appear in Revenue Account
   c. Compute the commission expense that will be charged to Revenue account
   d. Prepare claims statement or compute claims' amount that will appear in Revenue account

   Following tables should be useful in this regard:

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Computing Net change in Reserve for Unexpired risk	Amount in Rs.
Closing balance of Reserve for Unexpired risk computed at prescribed rates on Net Premium	XXX
Less: Opening balance of Reserve for Unexpired risk	(XXX)
Charge / (income)	**XXX**

Computing Net Premium income to be credited to Revenue Account	Amount in Rs.
Premium on new policies	XXX
Add: Renewal premium	XXX
Add: Premium on Reinsurance accepted	XXX
Less: Premium on Reinsurance ceded	(XXX)
Net Premium	XXX
Less: Charge for change in Reserve for Unexpired risk **Or** Add: Income for change in Reserve for Unexpired risk	(XXX)
Net Premium earned	**XXX**

Computing Net Commission to be charged to Revenue Account	Amount in Rs.
Commission on new policies	XXX
Add: Commission on renewals, if any	XXX
Add: Commission paid on reinsurance accepted	XXX
Less: Commission received on Reinsurance ceded	(XXX)
TOTAL	**XXX**

Net Claims incurred to be charged to Revenue Account	Amount in Rs.	
Charge relating to Direct business (expense / liability)		
Closing balance of claims payable	XXX	
Add: Claims paid during the year	XXX	
Add: Expenses in connection with settlement of claims		
Less: Opening balance of claims payables	(XXX)	XXX
Add: Charge relating to Reinsurance business accepted (expense / liability)		
Closing balance of claims payable	XXX	
Add: Claims paid during the year	XXX	
Less: Opening balance of claims payables	(XXX)	XXX
Less: Related to Reinsurance business ceded (income / asset)		
Closing balance of claims receivables	(XXX)	
Add: Claims received during the year	(XXX)	
Less: Opening balance of claims receivables	XXX	(XXX)
TOTAL		**XXX**

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Formulae in this table are arrived at using the below basic principles:

(a) Op. Bal. of payables + Charge during the year – Claims paid = Cl. Bal. of payables

Thus, Charge = Cl. Bal. + Claims paid – Op. Bal. (same is exhibited above in the table)

(b) Op. Bal. of receivables + Income for the year – Claims received = Cl. Bal. of receivables

Thus, Income = Cl. Bal. + Claims received – Op. Bal. (same is exhibited above in the table)

2. Questions may ask to prepare Revenue Account/ Policyholders' Account / Technical Account

   a. Apart from workings in #1 above, some other workings may also be required like:
      - ✓ Transferring prescribed percentages to other funds / reserves viz. Catastrophe Reserve in case of general insurance, life fund in case of life insurance etc.
      - ✓ Declaring dividend
      - ✓ Making other adjustments as specified

   b. Appropriate working notes, including ledgers if required, should be prepared for all the adjustments specified in the question, before preparing Revenue Account.

   c. Following pointers may be useful in this regard:
      - ✓ Any expenses towards claim settlement (viz. legal, survey etc.) would be added to amount of net claims charged to Revenue Account.
      - ✓ If such expenses are included in management expenses or any other head, exclude from there.

3. Questions may also ask to prepare P/L and B/S too. Pls see key formats (statutory formats prescribed by IRDA). Appropriate schedules to financial statements would also need to be prepared (schedule numbers are also prescribed and need to be followed as it is).

   a. Following pointers may be useful in this regard:
      - ✓ Incomes / expenses in excess of 1% of total premium (less reinsurance) or Rs 5,00,000 whichever is higher, should be shown as separate line item
      - ✓ Rental income to include realized rent only, and not any notional rent

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Illustration – 1

Indian insurance company limited furnishes you with the following information:

(i) On 31.12.20X1 it had reserve for unexpired risk to the tune of Rs. 40 crores.

(ii) It comprised of Rs 15 crores in respect of marine insurance business: Rs 20 crores in respect of fire insurance business and Rs 5 crores in respect of miscellaneous insurance business.

(iii) It is the practice of Indian Insurance Co. Ltd. to create reserves at 100% of net premium income in respect of marine insurance policies and at 50% of net premium income in respect of fire and miscellaneous income policies.

(iv) During 20X2, the following business was conducted:

(Rs. Crores)

	Marine	Fire	Miscellaneous
Premia collected from:			
(a) Insureds in respect of policies issued	18	43	12
(b) Other insurance companies in respect of risks undertaken	7	5	4
Premia paid/payable to other insurance companies on business ceded	6.7	4.3	7

Indian Insurance Co. Ltd. asks you to:

(a) Pass journal entries relating to "Unexpired risks reserve".

(b) Show in columnar form "Unexpired risks reserve" a/c for 20X2.

[Source - ICAI]

Illustration 2

Janani Assurance Co. Ltd. received ₹5,90,000 as premium on new policies and ₹ 1,20,000 as renewal premium. The company received ₹90,000 towards reinsurance accepted and paid ₹70,000 towards reinsurance ceded. How much will be credited to Revenue Account towards premium?

Illustration 3

From the following figures appearing in the books of Fire Insurance division of a General Insurance Company, show the amount of claim as it would appear in the Revenue Account for the year ended 31st March, 20X2:

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	Direct business	Re- insurance
Claim paid during the year	46,70,000	7,00,000
Claim Payable — 1st April, 2012 31st March 2012	7,63,000 8,12,000	87,000 53,000
Claims received		2,30,000
Claims Receivable — 1st April 2012 31st March 2012	_ _	65,000 1,13,000
Expenses of Management (includes Rs.35,000 Surveyor's fee and Rs.45,000 Legal expenses for settlement of claims)	2,30,000	_

Illustration 4

From the following information of Reliable Marine Insurance Ltd. for the year ending 31st March 2012 find out the

i. Net premium earned

ii. Net claims incurred

(Rs)

	Direct business	Re-insurance
Premium:		
Received	88,00,000	7,52,000
Receivable -1.04.2011	4,39,000	36,000
Receivable -31.03.2012	3,77,000	32,000
Paid:		
Payable- 1.04.2011		27,000
Payable – 31.03.2012		18,000
Claims:		
Paid	69,00,000	5,54,000
Payable – 1.04.2011	89,000	15,000
Payable - 31.03.2012	95,000	12,000
Received		2,01,000
Receivable –1.04.2011		
Receivable - 31.03.2012		40,000 38,000

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Illustration 5

Prepare Revenue Account in proper form for the year ended 31st March 2011 from the following particulars related to Goma General Insurance Co. for the year 2011-2012

	Direct Business	Re-Insurance
Premiums: Amount received	30,00,000	2,40,000
Receivable at the beginning Receivable at the end	1,80,000 2,40,000	24,000 36,000
Amount paid Payable at the beginning Payable at the end	_	3,60,000 30,000 42,000
Claims: Amount paid Payable at the beginning Payable at the end	18,00,000 60,000 1,20,000	1,80,000 12,000 18,000
Amount recovered Receivable at the beginning Receivable at the end	_ _ _	1,20,000 18,000 12,000
Commission: Amount paid Amount received	72,000 _	10,800 14,400

Additional information:

i. *Interest, dividend and rent received* *30,000*

Income-tax in respect of above *6,000*

Management expenses including Rs.12,000 related to

Legal expenses regarding claims *132,000*

(ii)Provision for income tax existing at the beginning of the year was Rs. 1,95,000 the income – tax actually paid during the year Rs.1,68,000 and the provision necessary at the yearend Rs. 2,07,000

The net premium income of the company during the year 2010-2011 was Rs. 24,00,000 on which reserves for unexpired risk @ 50% and additional reserve @7 ½ % was created. This year the balance to be created forward to be carried forward is 50% of net premium on reserves for unexpired risk and 5% on additional reserves.

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IND AS 1
PRESENTATION OF FINANCIAL STATEMENTS

1 Objective

- Prescribes the basis for presentation of general purpose financial statements to ensure comparability with the previous years of the entity and with other entities.
- Overall requirements for the presentation of financial statements
- Structure and minimum requirements for the content of financial statements

2 Scope

This Ind AS is applicable to

- All types of entities preparing and preparing and presenting general purpose financial statements. This includes both consolidated and separate financial statements. (but does not apply to structure and content of condensed interim financial statements prepared in accordance with Ind AS 34 except few points.)
- All types of entities including profit and non profit oriented and entities whose share capital is not considered as equity.
- This Standard uses terminology that is suitable for profit-oriented entities, including public sector business entities.
- If any non profit oriented entity is preparing Ind AS financial statements, it needs to modify the terminology as needed.

3 Definitions

3.1 General purpose financial statements

General purpose financial statements are those intended to meet the needs of users who are not in a position to require an entity to prepare reports tailored to their particular information needs.

3.2 Owners

Owners are holders of instruments classified as equity. It means a holder of redeemable preference share capital cannot be called as owner, as redeemable preference share capital is a liability but not equity.

3.3 Other Comprehensive Income

The other comprehensive income section should present line items for the amounts of other comprehensive income classified by nature and grouped into those that, in accordance with other Ind AS:

- Will not be reclassified subsequently to profit or loss; and
- Will be reclassified subsequently to profit or loss when specific conditions are met.

4 Complete set of financial statements

A complete set of financial statements comprises:

- a **balance sheet** as at the end of the period
- a **statement of profit and loss** for the period
- **statement of changes in equity** for the period
- a statement of **cash flows** for the period
- **notes**, comprising Material Accounting Policies and other explanatory information
- **comparative information** in respect of the preceding period
- **a balance sheet as at the beginning of the preceding period** when
    - an entity applies an accounting policy retrospectively or
    - makes a retrospective restatements of items in its financial statements, or
    - when it reclassifies items in its financial statements.

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An entity shall present a single statement of profit and loss, with profit or loss and other comprehensive income presented in two sections. The sections shall be presented together, with the profit or loss section presented first followed directly by the other comprehensive income section.

Many entities present reports and statements (generally in annual reports) such as financial reviews by management, environmental reports, and value added statements that are outside the financial statements. Such reports and statements that are outside the financial statements are outside the scope of Ind AS.

5 General features of financial statements

5.1 Presentation of True and Fair view and compliance with Ind AS

Financial statements shall present a true and fair view of the financial position and financial performance and cash flows of the entity.

Presentation of true and fair view requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the Framework.

The application of Ind AS, with additional disclosure when necessary, is presumed to result in financial statements that present a true and fair view.

Presentation of a true and fair view also requires an entity:

- To **select and apply accounting policies** in accordance with Ind AS 8 'Accounting Policies, Changes in Accounting Estimates and Errors'. Ind AS 8 sets out a hierarchy of authoritative guidance that management considers in the absence of an Ind AS that specifically applies to an item.
- To present information, including accounting policies, in a manner that **provides relevant, reliable, comparable and understandable information.**
- To provide additional disclosures when compliance with the specific requirements in Ind AS is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance.

An entity cannot rectify inappropriate accounting policies either by disclosure of the accounting policies used or by notes or explanatory material.

5.1.1 Departure from compliance of Ind AS

In the extremely rare circumstances in which management concludes that compliance of an Ind AS would be so misleading that it would conflict with the objective of financial statements set out in the Framework. An entity shall depart from Ind AS requirement if the relevant regulatory framework requires, or otherwise does not prohibit, such a departure.

When an entity departs from a requirement of an Ind AS, it shall disclose:

(a) that the financial statements present a true and fair view as per management conclusion.
(b) that it has complied with applicable Ind AS, except the departure.
(c) Departed Ind AS information. Such as
    - The title of the Ind AS from which the entity has departed.
    - The nature of the departure, including the treatment that the Ind AS would require, the reason why that treatment would be so misleading in the circumstances that it would conflict with the objective of financial statements set out in the Conceptual Framework, and the treatment adopted; and

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(d) For each period presented, the financial effect of the departure on each item in the financial statements that would have been reported in complying with the requirement

5.2 Going Concern

While preparing the financial statements, management is required to assess, the entity's ability to continue as a going concern, and this assessment should cover the entity's prospects for at least 12 months from the end of the reporting period.

In general, an entity is assumed to be a going concern unless there is significant information to the contrary or there is no realistic alternative.
In making such assessment, they should consider all material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern. The entity should disclose such uncertainties.

When an entity does not prepare financial statements on a going concern basis, disclose

- The fact that entity does not have going concern.
- Basis of preparation of the financial statements.
- The reason why the entity is not regarded as a going concern.

If the management believes that an entity may no longer be a going concern,

- The entity should account for all its assets at net realizable value or a liquidation basis but not on the historical cost basis.
- It should disclose the basis of preparation of financials.
- The difference between the carrying amount and net realizable value should be taken to P&L a/c.

5.3 Accrual basis of accounting

An entity shall prepare its financial statements, except for cash flow information, using the accrual basis of accounting. It means to record the transaction whenever transaction occurs irrespective of flow of cash.

When the accrual basis of accounting is used, an entity recognises items as assets, liabilities, equity, income and expenses (the elements of financial statements) when they satisfy the definitions and recognition criteria for those elements in the framework.

5.4 Materiality and aggregation (Clubbing the items as one)

An entity shall present separately each material class of similar items. An entity shall present separately items of a dissimilar nature or function unless they are immaterial except when required by law.

Financial statements result from processing large numbers of transactions or other events that are aggregated into classes according to their nature or function. The final stage in the process of aggregation and classification is the presentation of condensed and classified data, which form line items in the financial statements. If a line item is not individually material, it is aggregated with other items either in those statements or in the notes. An item that is not sufficiently material to warrant separate presentation in those statements may warrant separate presentation in the notes.
An entity need not provide a specific disclosure required by an Ind AS if the information is not material except when required by law.

5.5 Offsetting

- An entity shall not offset assets and liabilities or income and expenses, unless required or permitted by an Ind AS.

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- An entity reports separately both assets and liabilities, and income and expenses. Measuring assets net of valuation allowances — for example, obsolescence allowances on inventories and doubtful debts allowances on receivables—is not offsetting.
- Ind AS 115, 'Revenue from Contracts with Customers', requires an entity to measure revenue from contracts with customers at the amount of consideration to which the entity expects to be entitled in exchange for transferring promised goods or services.
  For example:
  The amount of revenue recognized reflects any trade discounts and volume rebates the entity allows. An entity undertakes, in the course of its ordinary activities, other transactions that do not generate revenue but are incidental to the main revenue-generating activities. An entity presents the results of such transactions, when this presentation reflects the substance of the transaction or other event, by netting any income with related expenses arising on the same transaction.
- An entity presents on a net basis gains and losses arising from a group of similar transactions, for example, foreign exchange gains and losses or gains and losses arising on financial instruments held for trading. However, an entity presents such gains and losses separately if they are material.

5.6 Frequency of reporting

An entity shall present a complete set of financial statements (including comparative information) at least annually.

When an entity changes the end of its reporting period and presents financial statements for a period longer or shorter than one year, an entity shall disclose, in addition to the period covered by the financial statements:

- the reason for using a longer or shorter period, and
- the fact that amounts presented in the financial statements are not entirely comparable

5.7 Comparative information

Minimum comparative information

- An entity should present comparative information in respect of the preceding period for all amounts reported in the current period's financial statements except when Ind AS permit or require otherwise.
- Comparative information for narrative and descriptive information should be included if it is relevant to understand the current period's financial statements.
- An entity shall present, as a minimum:
  - ✓ 2 Balance Sheets
  - ✓ 2 Statement of Profit and Loss
  - ✓ 2 Statement of Cash Flows
  - ✓ 2 Statement of Changes in Equity and
  - ✓ Related Notes

Additional comparative information

An entity may present comparative information in addition to the minimum comparative financial statements required by Ind ASs, as long as that information is prepared in accordance with Ind AS. This comparative information may consist of one or more statements referred to in 'Complete set of financial statements' but need not comprise a complete set of financial statements. When this is the case, the entity shall present related note information for those additional statements.

Third Balance Sheet date

If current year ended is 31-03-20X8, previous year comparative is 31-03-20X7 & opening balance sheet of previous year is 01-04-20X7.

An entity shall present a third balance sheet as at the beginning of the preceding period in addition to the minimum comparative financial statements required if:

- It applies an accounting policy retrospectively, makes a retrospective restatement of items in its financial statements or reclassifies items in its financial statements; and
- The retrospective application, retrospective restatement or the reclassification has a material effect on the information in the balance sheet at the beginning of the preceding period.

An entity shall reclassify the comparative amounts also unless it is impracticable. If it reclassifies, it should disclose the following

- The nature of reclassification
- The amount of each item or class of items that is reclassified
- The reason for reclassification

In case of impracticability, disclose the reason and nature of adjustments that would have been reclassifies.

5.8 Consistency of Presentation

An entity shall retain the presentation and classification of items in the financial statements from one period to the next unless:

- it is apparent, following a significant change in the nature of the entity's operations or a review of its financial statements, that another presentation or classification would be more appropriate having regard to the criteria for the selection and application of accounting policies in Ind AS 8; or
- an Ind AS requires a change in presentation

6 Identification of Financial Statements

An entity shall clearly identify the financial statements and distinguish them from other information in the same published document. Ind AS apply only to financial statements, and not necessarily to other information presented in an annual report, a regulatory filing, or another document though they may be useful to users.

An entity shall display the following information prominently:

- the name of the reporting entity or other means of identification, and any change in that information from the end of the preceding reporting period
- whether the financial statements are of an individual entity or a group of entities;
- reporting date or the reporting period
- the presentation currency
- the level of rounding used in presenting amounts in the financial statements.

Usage of any unit of the presentation currency is acceptable as long as the entity discloses the level of rounding and does not omit material information.

An entity meets above requirements by presenting appropriate headings for pages, statements, notes, columns and the like. Judgement is required in determining the best way of presenting such information.

An entity often makes financial statements more understandable by presenting information in thousands or millions of units of the presentation currency. This is acceptable as long as the entity discloses the level of rounding and does not omit material information.

7 Balance Sheet

At a minimum, the balance sheet shall include following items:

a) Property, plant and equipment
b) Investment property
c) Intangible assets
d) Financial assets (excluding amounts shown under (e, h &i)
e) Investments accounted for using the equity method
f) Biological assets

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g) Inventories
h) Trade and other receivables
i) Cash and cash equivalents
j) The total of assets classified as held for sale and assets included in disposal groups classified as held for sale in accordance with Ind AS 105 Non-current Assets Held for Sale and Discontinued Operations
k) Trade and other payables
l) Provisions
m) Financial liabilities (excluding amounts shown under k and l)
n) Liabilities and assets for current tax, as defined in Ind AS 12 Income Taxes
o) Deferred tax liabilities and deferred tax assets, as defined in Ind AS 12
p) Liabilities included in disposal groups classified as held for sale in accordance with Ind AS 105
q) Non-controlling interests, presented within equity
r) Issued capital and reserves attributable to owners of the parent

Additional line items, headings and subtotals in the balance sheet should be presented when such presentation is relevant to an understanding of the entity's financial position.
The descriptions of the line items, and the order in which they are shown, can be adapted according to the entity's nature and its transactions.

8 Current/Non-current distinction

An entity shall present current and non-current assets, and current and non-current liabilities, as separate classifications in its balance sheet.

8.1 Current Assets

An entity shall classify an asset as current when:

- It expects to realise the asset, or intends to sell or consume it, in its normal operating cycle;
- It holds the asset primarily for the purpose of trading;
- It expects to realise the asset within twelve months after the reporting period; or
- The asset is cash or a cash equivalent (as defined in Ind AS 7) unless the asset is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting period.

Operating Cycle:
The operating cycle of an entity is the time between the acquisition of assets (raw materials) for processing and their realisation in cash or cash equivalents. When the entity's normal operating cycle is not clearly identifiable, it is assumed to be twelve months.

Current assets include assets (such as inventories and trade receivables) that are sold, consumed or realised as part of the normal operating cycle even when they are not expected to be realised within twelve months after the reporting period. Current assets also include assets held primarily for the purpose of trading.

An entity shall classify all other assets as non-current.
This Standard uses the term 'non-current' to include tangible, intangible and financial assets of a long-term nature. It does not prohibit the use of alternative descriptions as long as the meaning is clear.

9 Current Liabilities

An entity shall classify a liability as current when:

- It expects to settle the liability in its normal operating cycle;

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- It holds the liability primarily for the purpose of trading;
- The liability is due to be settled within twelve months after the reporting period; or
- It does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.

An entity shall classify all other liabilities as non-current.

Some current liabilities, such as trade payables and some accruals for employee and other operating costs, are part of the working capital used in the entity's normal operating cycle.
An entity classifies such operating items as current liabilities even if they are due to be settled more than twelve months after the reporting period.

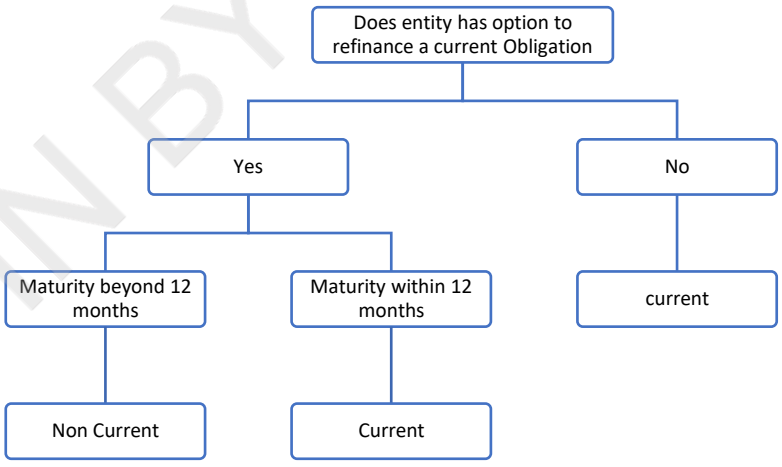
The same normal operating cycle applies to the classification of an entity's assets and liabilities.
When the entity's normal operating cycle is not clearly identifiable, it is assumed to be twelve months.

Other current liabilities which are not settled as part of the normal operating cycle, but are due for settlement within twelve months after the reporting period or held primarily for the purpose of trading

Financial liabilities that provide financing on a long-term basis (i.e. are not part of the working capital used in the entity's normal operating cycle) and are not due for settlement within twelve months after the reporting period **are non-current liabilities**.

An entity classifies its financial liabilities as current when they are due to be settled within twelve months after the reporting period, even if:

- the original term was for a period longer than twelve months, and
- an agreement to refinance, or to reschedule payments, on a long-term basis is completed after the reporting period and before the financial statements are approved for issue.



If an entity expects, and has the discretion, to refinance or roll over an obligation for at least twelve months after the reporting period under an existing loan facility, it classifies the obligation as non-current, even if it would otherwise be due within a shorter period. However, when refinancing or rolling over the obligation is not at the discretion of the entity (for example, there is no arrangement for refinancing), the entity does not consider the potential to refinance the obligation and classifies the obligation as current.

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When an entity breaches a provision of a long-term loan arrangement on or before the end of the reporting period with the effect that the liability becomes payable on demand, the entity does not classify the liability as current, even if the lender agreed, after the reporting period and before the approval of the financial statements for issue, not to demand payment as a consequence of the breach.

However, an entity classifies the liability as non-current if the lender agreed by the end of the reporting period to provide a period of grace ending at least twelve months after the reporting period, within which the entity can rectify the breach and during which the lender cannot demand immediate repayment

10 Information to be presented either in balance sheet or in notes

An entity shall disclose, either in the balance sheet or in the notes, further sub-classifications of the line items presented, classified in a manner appropriate to the entity's operations.
The detail provided in sub-classifications depends on the requirements of Ind AS and on the size, nature and function of the amounts involved.
An entity shall disclose the following, either in the balance sheet or in the statement of changes in equity which is part of the balance sheet, or in the notes:

- for each class of share capital:
  - ✓ the number of shares authorised;
  - ✓ the number of shares issued and fully paid, and issued but not fully paid;
  - ✓ par value per share, or that the shares have no par value;
  - ✓ a reconciliation of the number of shares
  - ✓ the rights, preferences and restrictions attaching to that class including restrictions on the distribution of dividends and the repayment of capital;
  - ✓ shares in the entity held by the entity or by its subsidiaries or associates; and
  - ✓ shares reserved for issue under options and contracts for the sale of shares, including terms and amounts; and
- a description of the nature and purpose of each reserve within equity.

An entity whose capital is not limited by shares e.g., a company limited by guarantee, shall disclose information, showing changes during the period in each category of equity interest, and the rights, preferences and restrictions attaching to each category of equity interest.

11 Statement of Profit and Loss

The statement of profit and loss shall present, in addition to the profit or loss and other comprehensive income sections:

(a) profit or loss;
(b) total other comprehensive income;
(c) Comprehensive income for the period, being the total of profit or loss and other comprehensive income.

An entity shall present (in case of consolidated statement of profit and loss) the following items as allocation of profit or loss and other comprehensive income for the period:

(a) profit or loss for the period attributable to:
  - Non-controlling interests, and
  - Owners of the parent.

(b) Comprehensive income for the period attributable to
  - Non-controlling interests, and
  - Owners of the parent.

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12 Information to be presented in the profit or loss section of the statement of profit and loss

In addition to items required by other Ind AS, the profit or loss section of the statement of profit and loss should include line items that present the following amounts for the period:

(a) revenue, presenting separately interest revenue calculated using the effective interest method
(b) gains and losses arising from the derecognition of financial assets measured at amortised cost
(c) finance costs
(d) impairment losses (including reversals of impairment losses or impairment gains)
(e) share of the profit or loss of associates and joint ventures accounted for using the equity method
(f) If financial asset is reclassified out of the amortised cost measurement category so that it is measured at fair value through profit or loss, any gain or loss arising from a difference between the previous amortised cost of the financial asset and its fair value at the reclassification date
(g) if a financial asset is reclassified out of the fair value through other comprehensive income measurement category so that it is measured at fair value through profit or loss, any cumulative gain or loss previously recognized in other comprehensive income that is reclassified to profit or loss
(h) tax expense
(i) a single amount for the total discontinued operations

13 Information to be presented in Other Comprehensive Income Section

The other comprehensive income section should present line items for the amounts of other comprehensive income classified by nature and grouped into those that, in accordance with other Ind AS

- will not be reclassified subsequently to profit or loss; and
- will be reclassified subsequently to profit or loss when specific conditions are met.

An entity shall present additional line items, headings and subtotals in the statement of profit and loss, when such presentation is relevant to an understanding of the entity's financial performance.

When an entity presents subtotals, those subtotals shall:

- be comprised of line items made up of amounts recognised and measured in accordance with Ind AS;
- be presented and labelled in a manner that makes the line items that constitute the sub total clear and understandable;
- be consistent from period to period; and
- not be displayed with more prominence than the subtotals and totals required in Ind AS for the statement of profit and loss.

An entity shall present the line items in the statement of profit and loss that reconcile any sub totals presented with the subtotals or totals required in Ind AS for such statement.
An entity shall not present any items of income or expense as extraordinary items, in the statement of profit and loss or in the notes

14 Profit and Loss for the period

With regard to profit or loss for the period, the Standard requires the recognition of all items of income and expense in a period in profit or loss unless an Ind AS requires or permits otherwise.

15 Other Comprehensive income for the period

With regard to other comprehensive income for the period, the Standard requires to disclose the amount of income tax relating to each item of other comprehensive income, including reclassification adjustments, either in the statement of profit and loss or in the notes.
An entity may present items of other comprehensive income either:

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(a) net of related tax effects, or
(b) before related tax effects with one amount shown for the aggregate amount of income tax relating to those items.

The Standard further prescribes that an entity should disclose reclassification adjustments relating to components of other comprehensive income.

Other Ind AS specify whether and when amounts previously recognised in other comprehensive income are reclassified to profit or loss. Such reclassifications are referred to in this Standard as reclassification adjustments.

A reclassification adjustment is included with the related component of other comprehensive income in the period that the adjustment is reclassified to profit or loss.

16 Information to be presented in the statement of Profit and Loss or in notes

When items of income or expense are material, an entity shall disclose their nature and amount separately. Circumstances that would give rise to the separate disclosure of items of income and expense include:

- Write-downs of inventories to net realisable value or of property, plant and equipment to recoverable amount, as well as reversals of such write-downs.
- restructurings of the activities of an entity and reversals of any provisions for the costs of restructuring;
- disposals of items of property, plant and equipment;
- disposals of investments;
- discontinued operations;
- litigation settlements; and
- Other reversals of provisions.

An entity shall present an analysis of expenses recognised in profit or loss using a classification based on the nature of expense method.

17 Statement of Changes in Equity

An entity shall present a statement of changes in equity which includes all changes in equity. It includes both - relating to performance and owner changes in equity (from transactions and events that increase or decrease equity but are not part of performance). The statement of changes in equity includes the following information:

a. total comprehensive income for the period, showing separately the total amounts attributable to owners of the parent and to non-controlling interests.
b. for each component of equity, the effects of retrospective application or retrospective restatement recognised in accordance with Ind AS 8.
c. for each component of equity, a reconciliation between the carrying amount at the beginning and the end of the period, separately disclosing each change resulting from:
    - profit or loss
    - each item of other comprehensive income
    - Transactions with owners in their capacity as owners, showing separately contributions by and distributions to owners and changes in ownership interests in subsidiaries that do not result in a loss of control; and
    - Any item recognised directly in equity such as amount recognised directly in equity as capital reserve with Ind AS 103.

18 Information to be presented in the statement of changes in equity or in the notes

An entity shall present, either in the statement of changes in equity or in the notes, an analysis of other comprehensive income by item.

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An entity shall present, either in the statement of changes in equity or in the notes, the amount of dividends recognised as distributions to owners during the period, and the related amount of dividends per share.

Ind AS 8 requires retrospective adjustments to effect changes in accounting policies, to the extent practicable, except when the transition provisions in another Ind AS require otherwise. Ind AS 8 also requires restatements to correct errors to be made retrospectively, to the extent practicable. Retrospective adjustments and retrospective restatements are not changes in equity but they are adjustments to the opening balance of retained earnings, except when an Ind AS requires retrospective adjustment of another component of equity.

Disclosure in the statement of changes in equity of the total adjustment to each component of equity resulting from changes in accounting policies and, separately, from corrections of errors. These adjustments are disclosed for each prior period and the beginning of the period.

19 Statement of Cash Flows

Cash flow information provides users of financial statements with a basis to assess the ability of the entity to generate cash and cash equivalents and the needs of the entity to utilise those cash flows.
An entity should present a statement of cash flows in accordance with Ind AS 7, Statement of Cash Flows.
Structure
The notes shall:

a. Present information about the basis of preparation of the financial statements and the specific accounting policies used.
b. Disclose the information required by Ind AS that is not presented elsewhere in the financial statements; and
c. Provide information that is not presented elsewhere in the financial statements but is relevant to an understanding of any of them.

An entity shall present notes in a systematic manner. In determining a systematic manner, the entity shall consider the effect on the understandability and comparability of its financial statements.
An entity shall cross-reference each item in the balance sheet, in the statement of changes in equity, in the statement of profit and loss, and statement of cash flows to any related information in the notes.

20 Disclosures

20.1 Disclosure of accounting policies

An entity shall disclose its Material Accounting policies. Accounting policy information is material if it can reasonably be expected to influence decisions made by users of financial statements. Accounting policies related to immaterial transactions are not required to be disclosed.

Accounting policy information would be considered to be material if –

- The events related to material transactions, events or conditions
- Entity changed its accounting policy during the reporting period and this has resulted in a material change to the information in FS.
- Entity chose accounting policy from options permitted by Ind AS
- Accounting policy was developed in accordance with Ind AS in the absence of applicable Ind AS
- It relates to an area where entity is required to make significant judgement or assumptions
- Accounting required for the items is complex and would be difficult for the users to understand.

If a disclosure is required by a specific Ind AS it must be disclosed even if the management considers it to be immaterial

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An entity must disclose along with its Material Accounting policies or other notes, the judgments, apart from those involving estimations, that management has made in the process of applying the entity's accounting policies that have the most significant effect on the amounts recognised in the financial statements.

Sources of estimation uncertainty:
An entity must disclose, in the notes, information about the assumptions made concerning the future, and other important sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year. Disclosures about nature of such assets and their carrying amount as at the end of the reporting period should also be made.

Capital
An entity shall disclose information that enables users of its financial statements to evaluate the entity's objectives, policies and processes for managing capital.

20.2 Puttable financial instruments classified as equity (You will understand this after learning Financial Instruments)

For puttable financial instruments classified as equity instruments, an entity shall disclose (to the extent not disclosed elsewhere):

a. Summary quantitative data about the amount classified as equity
b. Its objectives, policies and processes for managing its obligation to repurchase or redeem the instruments when required to do so by the instrument holders, including any changes from the previous period.
c. The expected cash outflow on redemption or repurchase of that class of financial instruments; and
d. Information about how the expected cash outflow on redemption or repurchase was determined.

20.3 Other Disclosures

An entity must disclose the amount of dividends proposed or declared before the financial statements were approved for issue but not recognised as a distribution to owners during the period, and the related amount per share and the amount of any cumulative preference dividends not recognised.
Ind AS 1 requires certain other disclosures, if not disclosed elsewhere in information published with the financial statements:

a) the domicile and legal form of the entity, its country of incorporation and the address of its registered office (or principal place of business, if different from the registered office)
b) a description of the nature of the entity's operations and its principal activities
c) the name of the parent and the ultimate parent of the group; and
d) if it is a limited life entity, information regarding the length of its life.

21 Comparison with AS-1

The following are not covered in AS-1

- Complete set of financial statements
- Purpose and general features of FS
- Off-setting requirement (Specific AS prescribe requirement)
- Frequency of reporting
- Structure and content of FS
- Balance Sheet line items
- Statement of P&L line items

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- Reclassification of items
- Statements of changes in equity
- Comparative information
- Classification of long-term loan arrangement
- Rectification of accounting policies (not covered by AS-1)
- Sources of estimation uncertainty

AS 1 requires disclosures if the fundamental accounting assumption of going concern, consistency and accrual are not followed in preparation of FS. Ind AS 1 does not have such requirement. Ind AS 1 requires entity to follow accrual basis of accounting and compliance with all Ind AS.

22 Carve Out from IAS1

IAS 1 required that in case of a loan liability, if any condition of the loan agreement which was classified as non-current is breached on or before the reporting date, such loan liability should be classified as current even if the breach is rectified after balance sheet date.

Ind AS 1 requires that where there is such breach and the lender agreed before the approval of financial statements for issue not to demand payment as a consequence of breach, the entity shall not classify such loan as current.

Illustrations

1. Illustration

Entity XYZ is a large manufacturer of plastic products for the local market. On 1st April, 20X6 the newly elected government unexpectedly abolished all import tariffs, including the 40 per cent tariff on all imported plastic products. Many other economic reforms implemented by the new government contributed to the value of the country's currency Rs. appreciating significantly against most other currencies. The currency appreciation severely reduced the competitiveness of the entity's products.

Before 20X6 entity XYZ was profitable. However, because it was unable to compete with low priced imports, entity XYZ went into losses. As at 31st March, 20X7, entity XYZ's equity was Rs. 1,000. During the second quarter of financial year ended 31 March 20X7, the management restructured entity's operations. That restructuring helped reduce losses for the third and fourth quarters to Rs. 400 and Rs. 380, respectively. During the year ended 31st March, 20X7, entity XYZ reported a loss of Rs. 4,000. In January 20X7, the local plastic industry and labour union lobbied government to reinstate tariffs on plastic. On 15th March, 20X7, the government announced that it would reintroduce limited plastic import tariffs at 10 percent in 20X8. However, it emphasised that those tariffs would not be as protective as the tariffs enacted by the previous government. In its latest economic forecast, the government predicts a stable currency exchange rate in the short term with a gradual weakening of the jurisdiction's currency in the longer term.
Management of the entity XYZ undertook a going concern assessment at 31st March, 20X7. Management projects / forecasts that imposition of a 10 per cent tariff on the import of plastic products would, at current exchange rates, result in entity XYZ returning to profitability. How should the management of entity XYZ disclose the information about the going concern assessment in entity XYZ's 31st March, 20X7 annual financial statements?

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Hint: XYZ's liabilities could exceed its assets by the end of financial year 20X7-20X8. But entity XYZ is a going concern.

2. Illustration

In 20X8 entity 'Superb' was acquired by entity 'Happy Go Luck'. To align its reporting date with that of its parent, Superb changed the end of its annual reporting period from 31stJanuary to 31st March. Consequently, entity Superb's reporting period for the year ended 31st March, 20X8 is 14 months.
On the basis of these facts, what disclosure would be appropriate?
Hint: Comparative amounts for the statement of comprehensive income, statement of changes in equity, statement of cash flows and related notes are not entirely comparable.

3. Illustration

An entity produces whisky from barley, water, and yeast in a 24-month distillation process. At the end of the reporting period the entity has one month's supply of barley and yeast raw materials, 800 barrels of partly distilled whisky and 200 barrels of distilled whisky. Determine whether they are current assets.
Hint: Current Assets

4. Illustration

An entity owns a machine with which it manufactures goods for sale. It also owns the building in which it carries out its commercial activities. Determine whether they are current assets.

Hint: Non-Current Assets

5. Illustration

On 31 December 20X2, an entity replaced a machine in its production line. The replaced machine was sold to a competitor for Rs,3,00,000. Payment is due 15 months after the end of the reporting period. Determine the nature of payment due.

Hint: Receivable is a non-current asset

6. Illustration

On 1st April, 20X2, XYZ Ltd invested Rs.15,00,000 surplus funds in corporate bonds that bear interest at 8 percent per year. Interest is payable on the corporate bonds on 1st April, of each year. The principal is repayable in three annual instalments of Rs.5,00,000 starting from 1st April, 20X3. Determine if it is a current liability?

Hint: Rs.5,00,000 (repayable on 31/3/20X3)– Current assets & remaining Rs.10 lakhs non-current assets

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7. Illustration

On 1st April, 20X3, Charming Ltd issued 100,000 Rs. 10 bonds for Rs. 1,000,000. On 1st April, each year interest at the fixed rate of 8 percent per year is payable on outstanding capital amount of the bonds (ie the first payment will be made on 1st April, 20X4). On 1st April each year (i.e from 1st April, 20X4), Charming Ltd has a contractual obligation to redeem 10,000 of the bonds at Rs. 10 per bond. In its statement of financial position at 31st March, 20X4. How should this be presented in the financial statements?

Hint: Rs.9,00,000 non-current liability & Rs.1,80,000 current liabilities

8. Illustration

X Ltd provides you the following information:

- Raw material stock holding period: 3 months
- Work-in-progress holding period: 1 month
- Finished goods holding period: 5 months
- Debtor's collection period : 5 months

The trade payables of the Company are paid in 12.5 months. Should these be classified as current or non-current?

Hint: Trade payables – Current Liabilities

9. Illustration

Entity A has two different businesses, real estate and manufacturing of passenger vehicles. With respect to the real estate business, the entity constructs residential apartments for customers and the normal operating cycle is three to four years. With respect to the business of manufacture of passenger vehicles, normal operating cycle is 15 months. Under such circumstance where an entity has different operating cycles for different types of businesses, how classification into current and non-current be made?

Hint: Classification should be based the normal operating cycle that is relevant to that particular asset / liability.

10. Illustration

An entity has placed certain deposits with various parties. How the following deposits should be classified, i.e., current or non-current?

(a) Electricity Deposit

(b) Tender Deposit/Earnest Money Deposit [EMD]

(c) GST Deposit paid under dispute or GST payment under dispute.

Hint: (a) Non-Current (b) EMD based on terms of deposit (c) GST Deposit depends on facts of case

11. Illustration

Paragraph 69(a) of Ind AS 1 states "An entity shall classify a liability as current when it expects to settle the liability in its normal operating cycle". An entity develops tools for customers and this normally takes a period of around 2 years for completion. The material is supplied by the customer and hence the entity

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only renders a service. For this, the entity receives payment upfront and credits the amount so received to "Income Received in Advance". How should this "Income Received in Advance" be classified, i.e., current or non- current?

Hint: Current Liability

12. Illustration

An entity has taken a loan facility from a bank that is to be repaid within a period of 9 months from the end of the reporting period. Prior to the end of the reporting period, the entity and the bank enter into an arrangement, whereby the existing outstanding loan will, unconditionally, roll into the new facility which expires after a period of 5 years.

(a) How should such loan be classified in the balance sheet of the entity?

(b) Will the answer be different if the new facility is agreed upon after the end of the reporting period?

(c) Will the answer to (a) be different if the existing facility is from one bank and the new facility is from another bank?

(d) Will the answer to (a) be different if the new facility is not yet tied up with the existing bank, but the entity has the potential to refinance the obligation?

Hint: (a)Non-Current (b) Current (c) Current Liability (d) Current

13. Illustration

In December 20X1 an entity entered into a loan agreement with a bank. The loan is repayable in three equal annual instalments starting from December 20X5. One of the loan covenants is that an amount equivalent to the loan amount should be contributed by promoters by March 24 20X2, failing which the loan becomes payable on demand. As on March 24, 20X2, the entity has not been able to get the promoter's contribution. On March 25, 20X2, the entity approached the bank and obtained a grace period up to June 30, 20X2 to get the promoter's contribution.

The bank cannot demand immediate repayment during the grace period. The annual reporting period of the entity ends on March 31, 20X2.

(a) As on March 31, 20X2, how should the entity classify the loan?

(b) Assume that in anticipation that it may not be able to get the promoter's contribution by due date, in February 20X2, the entity approached the bank and got the compliance date extended up to June 30, 20X2 for getting promoter's contribution. In this case will the loan classification as on March 31, 20X2 be different from (a) above?

Hint: (a) Current (b) Non-Current

14. Illustration

OMN Ltd has a subsidiary MN Ltd. OMN Ltd provides a loan to MN Ltd at 8% interest to be paid annually. The loan is required to be paid whenever demanded back by OMN Ltd.

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How should the loan be classified in the financial statements of OMN Ltd? Will it be any different for MN Ltd?

Hint: Current

15. Illustration

An entity manufactures passenger vehicles. The time between purchasing of underlying raw materials to manufacture the passenger vehicles and the date the entity completes the production and delivers to its customers is 11 months. Customers settle the dues after a period of 8 months from the date of sale.

(a) Will the inventory and the trade receivables be current in nature?

(b) Assuming that the production time was say 15 months and the time lag between the date of sale and collection from customers is 13 months, will the answer be different?

Hint: (a) Current if realisable within normal operating cycle (b) No

16. Illustration

Company A has taken a long term loan from Company B. In the month of December 20X1, there has been a breach of material provision of the arrangement. As a consequence of which the loan becomes payable on demand on March 31, 20X2. In the month of May 20X2, the Company started negotiation with the Company B for not to demand payment as a consequence of the breach. The financial statements were approved for the issue in the month of June 20X2. In the month of July 20X2, both the companies agreed that the payment will not be demanded immediately as a consequence of breach of material provision. Advise on the classification of the liability as current / non-current.

Hint: Liability to be classified as current as at March 31, 20X2.

17. Illustration

Entity A has undertaken various transactions in the financial year ended March 31, 20X1. Identify and present the transactions in the financial statements as per Ind AS 1.

Remeasurement of defined benefit plans	2,57,000
Current service cost	1,75,000
Changes in revaluation surplus	1,25,000
Gains and losses arising from translating the monetary assets in foreign currency	75,000
Gains and losses arising from translating the financial statements of a foreign operation	65,000
Gains and losses from investments in equity instruments designated at fair value through other comprehensive income	1,00,000
Income tax expense	35,000
Share based payments cost	3,35,000

Hint: Items impacting (a) P&L – Service cost, translation gains/losses on forex, income tax, share based payments cost (b) OCI – Remeasurement, changes in surplus, translation gains / losses from foreign operations, gains / losses from investments.

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18. Illustration

XYZ Limited (the 'Company') is into the manufacturing of tractor parts and mainly supplying components to the Original Equipment Manufacturers (OEMs). The Company does not have any subsidiary, joint venture or associate company. During the preparation of financial statements for the year ended March 31, 20X1, the accounts department is not sure about the treatment/presentation of below mentioned matters. Accounts department approached you to advice on the following matters.

S. No.	Matters
(i)	There are qualifications in the audit report of the Company with reference to two Ind AS.
(ii)	Is it mandatory to add the word "standalone" before each of the components of financial statements?
(iii)	The Company is Indian Company and preparing and presenting its financial statements in Rs. Is it necessary to write in the financial statements that the financial statements has been presented in Rs.
(iv)	The Company had sales transactions with 10 related party parties during previous year. However, during current year, there are no transactions with 4 related parties out of aforesaid 10 related parties. Hence, Company is of the view that it need not disclose sales transactions with these 4 parties in related party disclosures because with these parties there are no transactions during current year.

Evaluate the above matters with respect to preparation and presentation of general-purpose financial statement.

Hint: (i) Yes (ii) No (iii) Yes (iv) No

19. Illustration

A Company presents financial results for three years (i.e one for current year and two comparative years) internally for the purpose of management information every year in addition to the general purpose financial statements. The aforesaid financial results are presented without furnishing the related notes because these are not required by the management for internal purpose. During current year, management thought why not they should present third year statement of profit and loss also in the general purpose financial statements. I t will save time and will be available easily whenever management needs this in future.

With reference to above background, answer the following:

(i) Can management present the third statement of profit and loss as additional comparative in the general-purpose financial statements?

(ii) If management present third statement of profit and loss in the general-purpose financial statement as comparative, is it necessary that this statement should be compliant of Ind AS?

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(iii) Can management present third statement of profit and loss only as additional comparative in the general-purpose financial statements without furnishing other components (like balance sheet, statement of cash flows, statement of change in equity) of financial statements?

Hint: (i) Yes (ii) Yes (iii) Yes

20. Illustration

A Company while preparing the financial statements for Financial Year (FY) 20X1-20X2, erroneously booked excess revenue of Rs. 10 Crore. The total revenue reported in FY 20X1-20X2 was Rs. 80 Crore. However, while preparing the financial statements for 20X2- 20X3, it discovered that excess revenue was booked in FY 20X1-20X2 which it now wants to correct in the financial statements. However, management of the Company is not sure whether it need to present the third balance sheet as additional comparative.
With regard to the above background, answer the following:
(i) Is it necessary to provide the third balance sheet at the beginning of the preceding period in this case?
(ii) The Company wants to correct the error during FY 20X2-20X3 by giving impact in the figures of current year only. Is the contention of management correct?

Hint: (i) No (ii) No

21. Illustration

XYZ Limited (the 'Company') is into construction of turnkey projects and has assessed its operating cycle to be 18 months. The Company has certain trade receivables and payables which are receivable and payable within a period of twelve months from the reporting date, i.e, March 31, 20X2.

In addition to above there are following items/transactions which took place during financial year 20X1-20X2.

S. No.	Items/transactions
(1)	The Company has some trade receivables which are due after 15 months from the date of balance sheet. So the Company expects that the payment will be received within the period of operating cycle.
(2)	The Company has some trade payables which are due for payment after 14 months from the date of balance sheet. These payables fall due within the period of operating cycle. Though the Company does not expect that it will be able to pay these payable within the operating cycle because the nature of business is such that generally projects gets delayed and payments from customers also gets delayed.
(3)	The Company was awarded a contract of Rs. 100 Crore on March 31, 20X2. As per the terms of the contract, the Company made a security deposit of 5% of the contract value with the customer, of Rs. 5 crore on March 31, 20X2. The contract is

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	expected to be completed in 18 months' time. The aforesaid deposit will be refunded back after 6 months from the date of the completion of the contract.
(4)	The Company has also given certain contracts to third parties and have received security deposits from them of Rs. 2 Crore on March 31, 20X2 which are repayable on completion of the contract but if contract is cancelled before the contract term of 18 months, then it becomes payable immediately. However, the Company does not expect the cancellation of the contract.

Considering the above items/transactions answer the following:

(i) The Company wants to present the trade receivable as current despite the fact that these are receivables in 15 months' time. Does the decision of presenting the same as current is correct?

(ii) The Company wants to present the trade payables as non-current despite the fact that these are due within the operating cycle of the Company. Does the decision of presenting the same as non-current is correct?

(iii) Can the security deposit of Rs. 5 Crore made by the Company with the customers be presented as current?

(iv) Can the security deposit of Rs. 2 Crore taken by the Company from contractors be presented as non-current?

Hint: (i) Yes (ii) No (iii) No (iv) No

22. Illustration

Is offsetting permitted under the following circumstances?

(a) Expenses incurred by a holding company on behalf of subsidiary, which is reimbursed by the subsidiary - whether in the separate books of the holding company, the expenditure and related reimbursement of expenses can be offset?

(b) Whether profit on sale of an asset against loss on sale of another asset can be offset?

(c) When services are rendered in a transaction with an entity and services are received from the same entity in two different arrangements, can the receivable and payable be offset?

Hint: (a) Yes, if in substance is in nature of reimbursement (b) Yes unless material (c) Yes if entity has legal right

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AS 2

INVENTORIES

1. Introduction

1.1 Objective

- To prescribe accounting treatment of inventories.
- Determination of cost of inventory.
- Subsequent recognition as an expense.
- Provides guidelines on cost formulas.

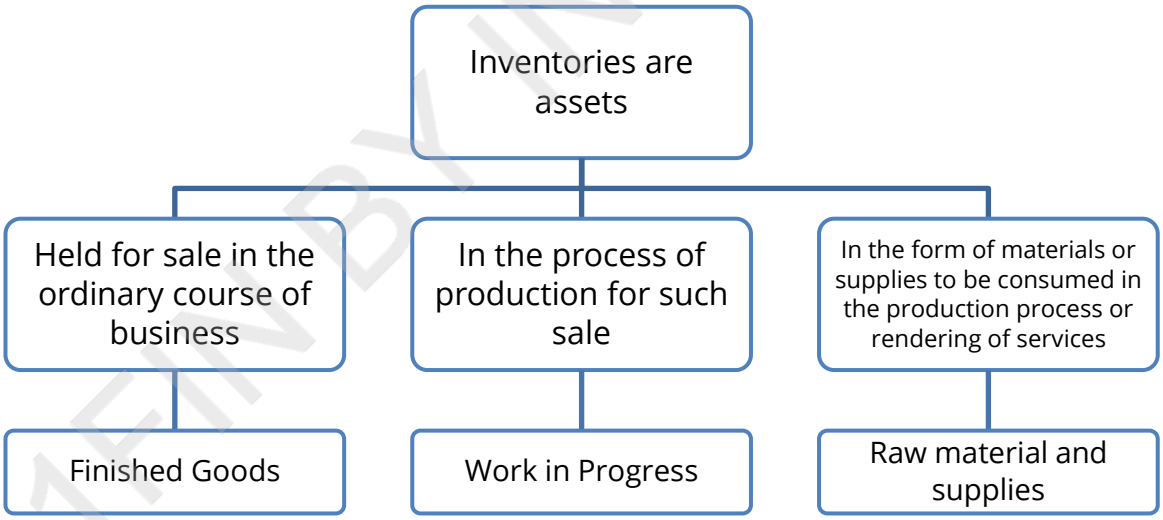
1.2 Scope

Standard applies to all inventories except

(a)	Financial Instruments	IndAS 109
(b)	Biological Assets related to Agriculture & Agriculture Produce at the point of Harvest. **Note : Produce post harvest will be covered under IndAS-2 and cost will be the value determined as per IndAS-41**	IndAS 41
(c)	Measurement of inventories held by - Producers of agricultural & forest products, minerals etc to the extent meausred at NRV in line with industry practice - Commodity broker-traders who measure inventories at FV less cost to sell	Recognition and disclosures criteria applies

2. Definitions

2.1 Inventories



2.2 Net Realisable Value (NRV)

NRV is the estimated selling price in the ordinary course of business less the estimated cost of completion and the estimated costs necessary to make the sale.

2.3 Fair Value

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

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3. Measurement

Golden Rule - Inventories are measured at lower of cost and net realisable value.

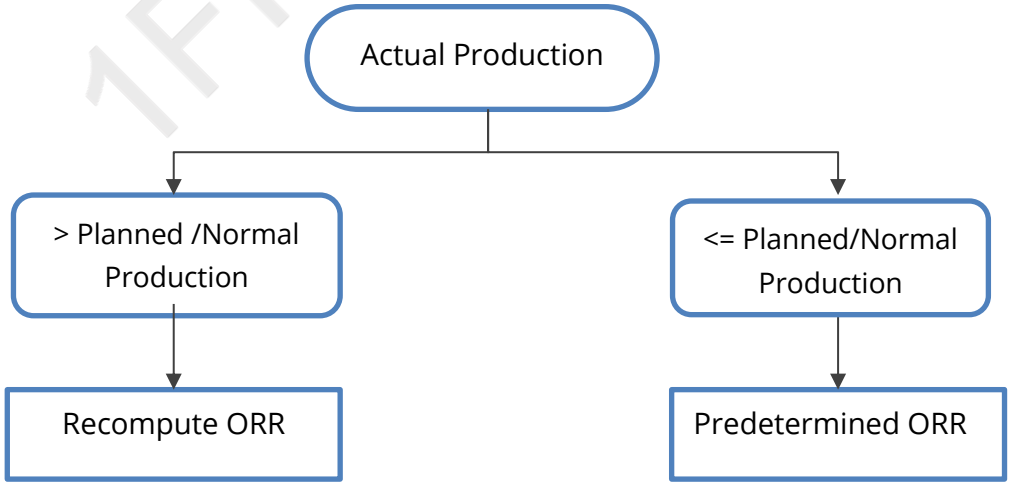
3.1 Cost of Inventories

PARTICULARS		AMOUNT
Cost of Purchases		
Purchase Price	XXX	
(+) Import duties & other taxes	XXX	
(+)Transport & handling charges	XXX	
(+) Other Costs to bring the inventory to present location & condition	XXX	
(-)Trade discounts, rebates & other similar items	(XXX)	XXX
Cost of Conversion		
Direct material	XXX	
(+) Direct labour	XXX	
(+) Other direct costs	XXX	
(+) Overheads (Fixed as well as variable overheads)*	XXX	XXX
Other Costs		
Costs incurred to bring the inventories to their present location & condition	XXX	
(+) Borrowing Cost under Ind AS 23	XXX	XXX
Cost of Inventory		**XXX**

3.2 Overhead

Fixed overhead is allocated based on predetermined overhead recovery rate (ORR) computed as below.

$$Pre\ Determined\ ORR = \frac{Budgeted\ Fixed\ OH}{Planned\ or\ Normal\ Production}$$



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3.3 Net Realisable Value

Estimated Selling Price	XXX
(-) Estimated costs to complete	(XXX)
(-) Estimated Costs to Sell	(XXX)
Net Realisable Value	XXX

- Estimates of NRV should be based on most reliable evidence available.
- Events occuring after balance sheet should be considered to the extent they provide additional evidence of events existing on balance sheet date.
- Price reductions in future should not be considered to determine NRV.
- If inventory is held for a firm contract to sell, the contracted price can be an evidence of NRV.

Write down of inventories should be done on an item to item basis and not on global basis.

3.4 Joint Products & By Products

Joint Products – Two or more products produced from a single process using common inputs. Each product has significant value. Example – Petrol, Diesel, Gas produced on refining crude.

Joint costs are allocated on the basis of relative sales value / NRV at split off point.

By Products – These are low value produces – generally considered as scrap.

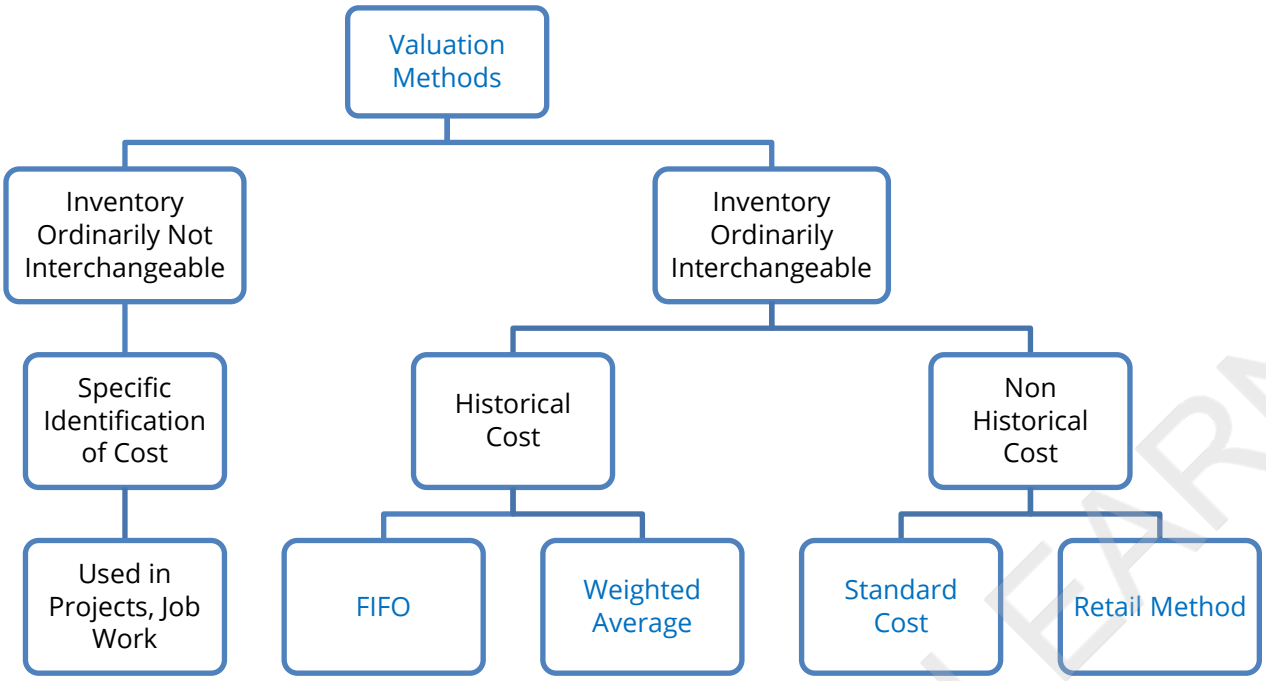
NRV of by products is reduced from joint costs if the by products are immaterial. If the by products are material, consider as Joint Products.

3.5 Cost measurement techniques

Retail Method	Standard Cost Method
Cost of Inventory = Expected Sales Value (-) Normal Gross Profit Margin	Standard cost is set considering standard usage of - Material - Labour - Overhead - Capacity utilisation

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3.6 Cost Formula



An entity shall use same cost formula for all inventories having a similar nature and use to the entity. For inventories with a different use , different cost formula can be used.

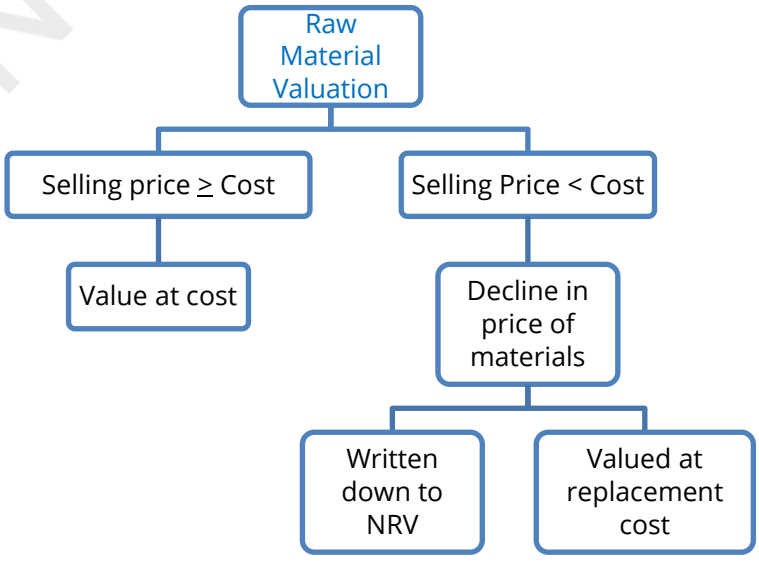
3.6.1 FIFO Method

- Assumption of cost flow : Inventory purchased first is sold first.
- Goods in Inventory are valued using the latest rates

3.6.2 Weighted Average Rate

- Cost is determined using a weighted average rate of goods received.
- The weighted average can be a periodic weighted average or a moving weighted average.

3.7 Raw Material Valuation



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4. Recognition of Expenses

Expense charged to P&L = Carrying amount of inventories sold + write down of inventories – reversals of write down.

The cost of some inventories may be allocated to other asset accounts. For example, inventory used as a component of self-constructed property, plant or equipment. Inventories allocated to another asset are recognised as an expense during the useful life of that asset through charging of depreciation on that asset (Ind AS 16)

5. Disclosures

Accounting policies including cost formula used.

- Analysis of carrying amount of inventory & carrying amount in classifications appropriate to the entity
- Carrying amount of inventories carried at fair value less cost to sell
- Carrying amount of inventories pledged as security
- Amounts recognised in profit or loss
    - Recognised as expense
    - Write down of inventory
    - Reversals of write down

6. IndAS 2 vs AS 2

There are no significant differences between the two standards

- IndAS 2 deals with recognition of expenses which is not dealt by AS-2
- IndAS 2 Explains inventories of service providers
- AS 2 deals with treatment of spare parts
- Ind AS 2 is not applicable to inventories of brokers/traders
- IndAS 2 covers concept of Fair value which is not covered by AS-2
- Agricultural produce are excluded from measurement aspects under IndAS-2. Under AS-2 these are fully excluded

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1. Illustration (RTP Nov 20)

A company normally produced 1,00,000 units of a high precision equipment each year over past several years. In the current year, due to lack of demand and competition, it produced only 50,000 units. Further information is as follows:

- Material = Rs. 200 per unit;
- Labour = Rs. 100 per unit;
- Variable manufacturing overhead = Rs. 100 per unit;
- Fixed factory production overhead =Rs. 1,00,00,000;
- Fixed factory selling overhead = Rs. 50,00,000;
- Variable factory selling overhead = Rs. 150 per unit.

Calculate the value of inventory per unit in accordance with Ind AS 2. What will be the treatment of fixed manufacturing overhead?

2. Illustration

In a manufacturing process of Mars ltd, one by-product BP emerges besides two main products MP1 and MP2 apart from scrap. Details of cost of production process are here under:

Item	Unit	Amount	Output	Closing Stock 31-03-X1
Raw material	14,500	1,50,000	MP 1-5,000 units	250
Wages	-	90,000	MP II - 4,000 units	100
Fixed overhead	-	65,000	BP- 2,000 units	
Variable overhead	-	50,000		

Average market price of MP1 and MP2 is Rs. 60 per unit and Rs. 50 per unit respectively, by- product is sold @ Rs. 20 per unit. There is a profit of Rs. 5,000 on sale of by-product after incurring separate processing charges of Rs. 8,000 and packing charges of Rs. 2,000, Rs. 5,000 was realised from sale of scrap.

Required: Calculate the value of closing stock of MP1 and MP2 as on 31-03-20X1.

3. Illustration

The following information relates to 20X1-20X2

Date	Particular	Unit	Cost	Total Cost

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			p.u.	
April	Inventory	200	10	2,000
May	Purchases	50	11	550
September	Purchases	400	12	4,800
February	Purchases	350	14	4,900
	Total	**1,000**		**12,250**
June	Sales	150		
October	Sales	300		
November	Sales	150		

Physical inventory at 31.03.20X2 400 units. Calculate ending inventory value and cost of sales using:

a. FIFO
b. Weighted Average

Under periodic and perpetual inventory system

4. Illustration (RTP May 2018)

On 31 March 20X1, the inventory of ABC includes spare parts which it had been supplying to a number of different customers for some years. The cost of the spare parts was Rs. 10 million and based on retail prices at 31 March 20X1, the expected selling price of the spare parts is Rs. 12 million. On 15 April 20X1, due to market fluctuations, expected selling price of the spare parts in stock reduced to Rs. 8 million. The estimated selling expense required to make the sales would Rs. 0.5 million. Financial statements were authorised by Board of Directors on 20th April 20X1.

As at 31st March 20X2, Directors noted that such inventory is still unsold and lying in the warehouse of the company. Directors believe that inventory is in a saleable condition and active marketing would result in an immediate sale. Since the market conditions have improved, estimated selling price of inventory is Rs. 11 million and estimated selling expenses are same Rs. 0.5 million.

What will be the value inventory at the following dates:

- 31st March 20X1
- 31st March 20X2

5. Illustration (RTP May 20)

The following is relevant information for an entity:

- Full capacity is 10,000 labour hours in a year.
- Normal capacity is 7,500 labour hours in a year.

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- Actual labour hours for current period are 6,500 hours.
- Total fixed production overhead is Rs. 1,500.
- Total variable production overhead is Rs. 2,600.
- Total opening inventory is 2,500 units.
- Total units produced in a year are 6,500 units.
- Total units sold in a year are 6,700 units.
- The cost of inventories is assigned by using FIFO cost formula.

How overhead costs are to be allocated to cost of goods sold and closing inventory?

6. Illustration

UA Ltd. purchased raw material @ Rs. 400 per kg. Company does not sell raw material but uses in production of finished goods. The finished goods in which raw material is used are expected to be sold at below cost. At the end of the accounting year, company is having 10,000 kg of raw material in inventory. As the company never sells the raw material, it does not know the selling price of raw material and hence cannot calculate the realizable value of the raw material for valuation of inventories at the end of the year. However, replacement cost of raw material is Rs. 300 per kg. How will you value the inventory of raw material?

7. Illustration

Sun Ltd. has fabricated special equipment (solar power panel) during 20X1-20X2 as per drawing and design supplied by the customer. However, due to a liquidity crunch, the customer has requested the company for postponement in delivery schedule and requested the company to withhold the delivery of finished goods products and discontinue the production of balance items.

As a result of the above, the details of customer balance and the goods held by the company as work-in-progress and finished goods as on 31-03-20X3 are as follows:

- Solar power panel (WIP) Rs. 85 lakhs
- Solar power panel (finished products) Rs. 55 lakhs
- Sundry Debtor (solar power panel) Rs. 65 lakhs

The petition for winding up against the customer has been filed during 20X2-20X3 by Sun Ltd. Comment with explanation on provision to be made of Rs. 205 lakh included in Sundry Debtors, Finished goods and work-in-progress in the financial statement of 20X2-20X3.

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8. Illustration

Night Ltd. sells beer to customers; some of the customers consumes the beer in the bars run by Night Limited. While leaving the bars, the consumers leaves the empty bottles in the bars and the company takes possession of these empty bottles. The company has laid down a detailed internal record procedure for accounting for these empty bottles which are sold by the company by calling tenders.

(i) Decide whether the stock of empty bottle is an asset of the company;

(ii) If so, whether the stock of empty bottles existing as on the date of

Balance Sheet is to be considered as inventories of the company & valued as per Ind AS-2 or to be treated as scrap and shown at realized value with corresponding credit to 'Other Income'?

9. Illustration

ABC Ltd. buys goods from an overseas supplier. It has recently taken delivery of 1,000 units of component X. The quoted price of component X wasRs.1,200 per unit but ABC Ltd. has negotiated a trade discount of 5% due to the size of the order.
The supplier offers an early settlement discount of 2% for payment within 30 days and ABC Ltd. intends to achieve this.
Import duties (basic custom duties) ofRs.60 per unit must be paid before the goods are released through custom. Once the goods are released through customs, ABC Ltd. must pay a delivery cost ofRs.5,000 to have the components taken to its warehouse. Calculate the cost of inventory

10. Illustration

ABC Ltd. manufactures control units for air conditioning systems. Each control unit requires the following:

- 1 component X at a cost ofRs.1,205 each
- 1 component Y at a cost ofRs.800 each
- Sundry raw materials at a cost ofRs.150 each

The company faces the following monthly expenses:

- Factory rentRs.16,500
- Energy costRs.7,500
- Selling and administrative costsRs.10,000
- Each unit takes two hours to assemble. Production workers are paid Rs.300 per hour.
- Production overheads are absorbed into units of production using an hourly rate. The normal level of production per month is 1,000 hours.

Determine the cost of inventory.

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11. Illustration

ABC Ltd. manufactures and sells paper envelopes. The stock of envelopes was included in the closing inventory as of 31st March, 20X1, at a cost ofRs.50 per pack.

During the final audit, the auditors noted that the subsequent sale price for the inventory at 15th April, 20X1, wasRs.40 per pack.

Furthermore, enquiry reveals that during the physical stock take, a water leakage has created damages to the paper and the glue. Accordingly, in the following week, ABC Ltd. has spent a total ofRs.15 per pack for repairing and reapplying glue to the envelopes.

Calculate the net realizable value

12. Illustration

At the end of its financial year, Company P has 100 units of inventory on hand recorded at a carrying amount of Rs.10 per unit. The current market price is Rs.8 per unit at which these units can be sold.

Company P has a firm sales contract with Company Q to sell 60 units at Rs.11 per unit, which cannot be settled net.

Estimated incremental selling cost is Rs. 1 per unit. Determine the Net Realisable Value (NRV) of the inventory of Company P.

13. Illustration

In Year 2, A business has four items of inventory. A count of the inventory has established that the amounts of inventory currently held, at cost, are as follows:

	Cost	Estimated Sales Price	Selling costs
Inventory Item A1	8,000	7,800	500
Inventory Item A2	14,000	18,000	200
Inventory Item B1	16,000	17,000	200
Inventory Item C1	6,000	7,500	150

Determine the value of closing inventory in the financial statements of a business.

14. Illustration

A dealer has purchased 1,000 cars costing Rs.2,80,000 each on deferred payment basis as 25,000 per month per car to be paid in 12 equal instalments.

At year end 31 March 20X1, twenty cars are in stock. What would be the cost of goods sold, finance cost and inventory carrying amount?

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15. Illustration

Particulars		Kg	Rs.
Opening Inventory	Finished Goods	1,000	25,000
	Raw Materials	1,100	11,000
Purchases		10,000	1,00,000
Labour			76,500
Overheads (Fixed)			75,000
Sales		10,000	2,80,000
Closing Inventory	Raw Materials	900	
	Finished Goods	1,200	

The expected production for the year was 15,000 kg of finished product.

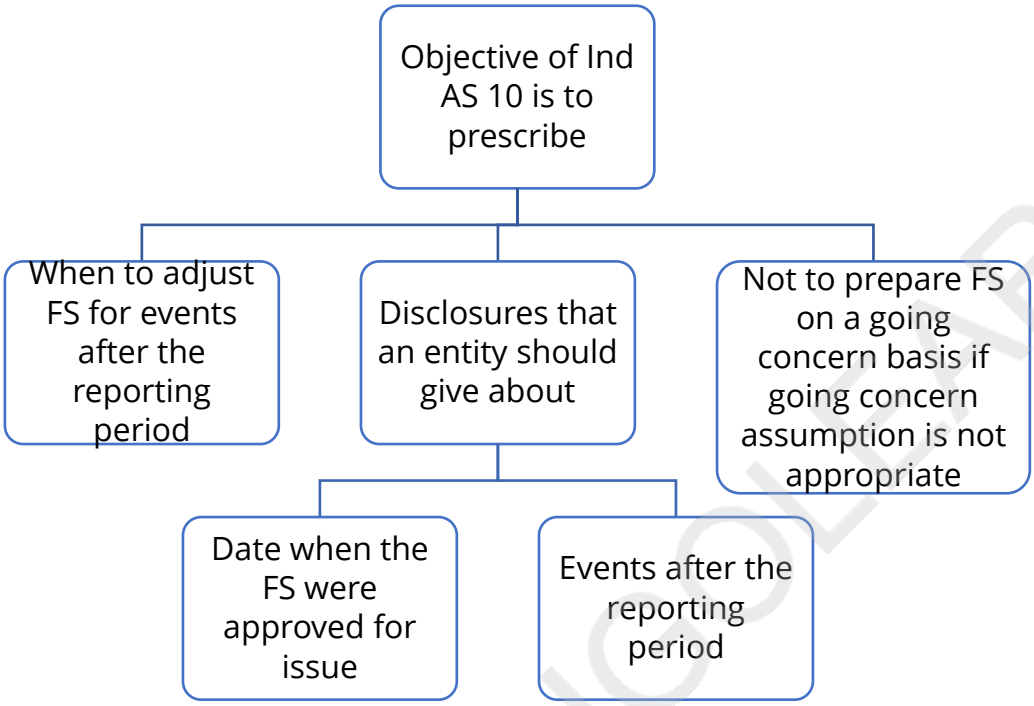
Due to fall in the market demand the sales price for the finished goods was Rs.20 per kg and the replacement cost for the raw material was Rs.9.50 per kg on the closing day.

You are required to calculate the closing inventory as on that date.

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Ind AS 10
EVENTS AFTER THE REPORTING PERIOD

1 Objective



2 Scope

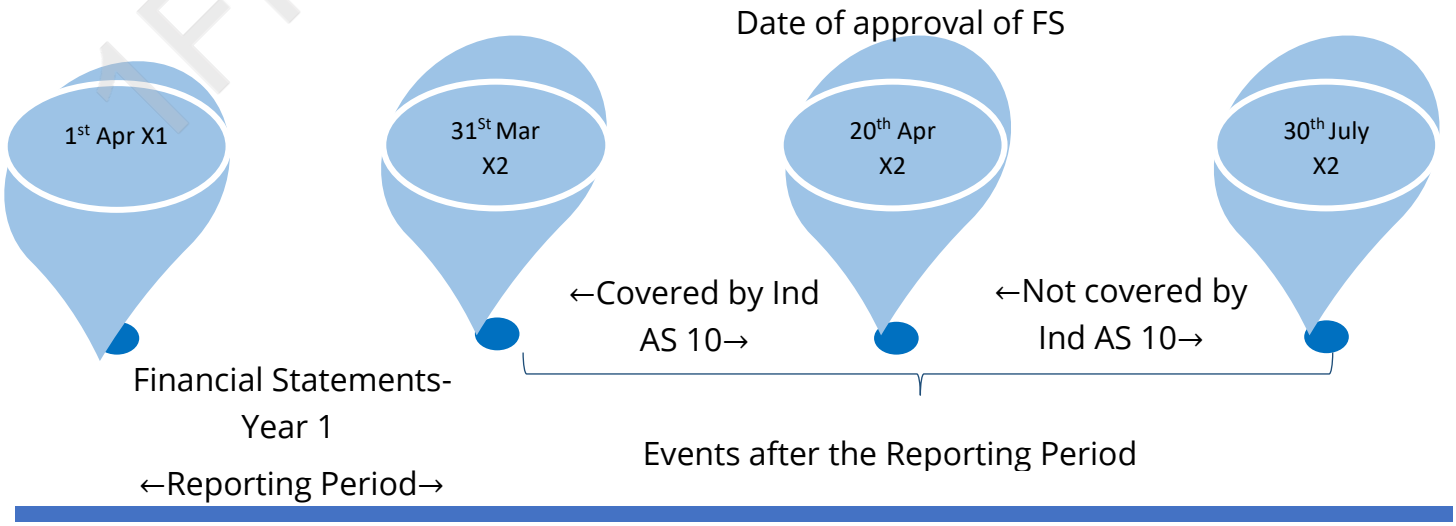
The Standard -shall be applied in,

- **Accounting** for events after reporting period and
- **Disclosure** of events after the reporting period.

3 Events after the Reporting Period

Those events, favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are approved

- by the **Board of Directors** in case of a **company** and
- by the **corresponding approving authority** in case of any **other entity** for issue.



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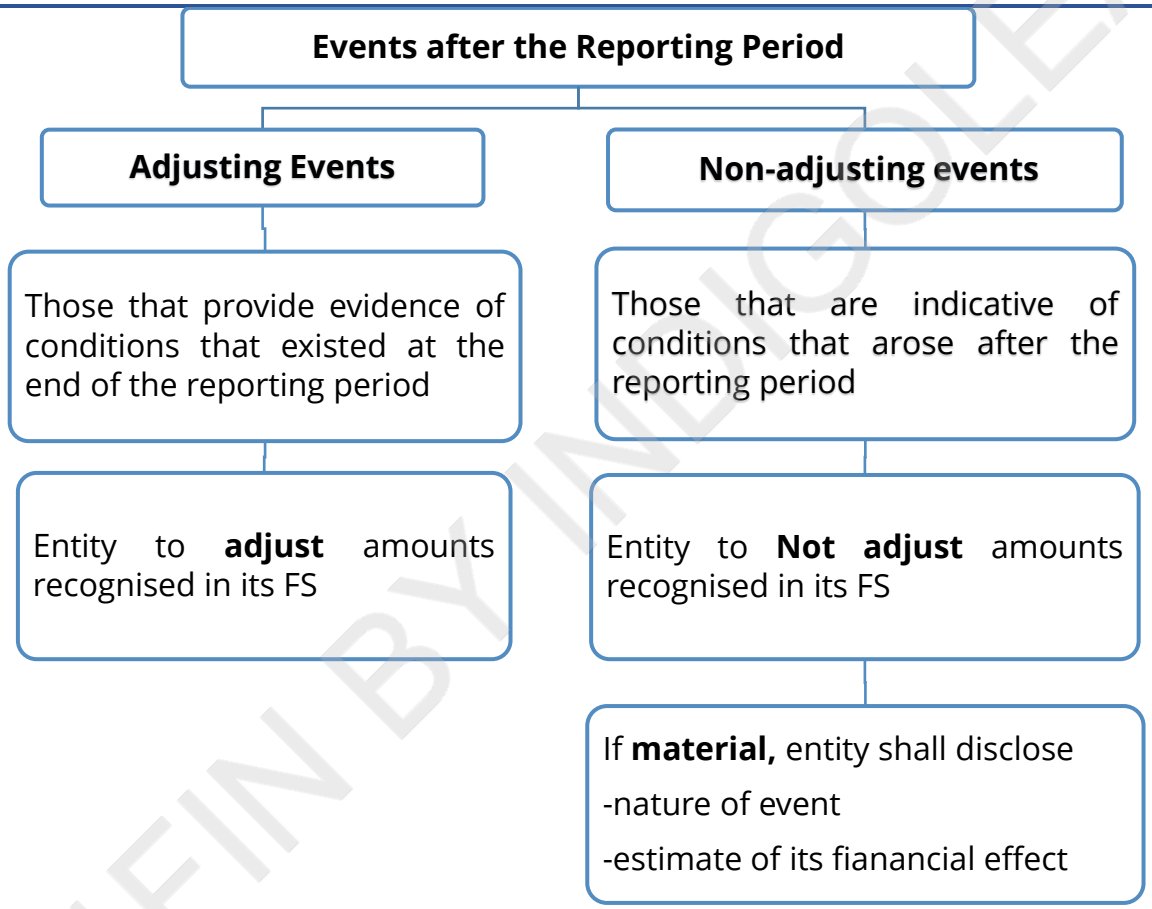
Date of approval Financial Statements

In case of a company	• The FS will be treated as approved when board of directors approves the same.
In the case of any other entity	• The FS will be treated as approved when the corresponding approving authority approves the same.

In some cases,

- the management of an entity is required to issue its financial statements to a **supervisory board** (made up solely of non-executives) for approval.
- in such cases, the financial statements are approved for issue when the **management approves** them for issue to the supervisory board.

4 Types of Events



4.1 Examples

Adjusting Events	✓ Contingent liability becomes an actual liability ✓ The receipt of information after the reporting period indicating that an asset (for e.g an Account Receivable) was impaired at the end of the reporting period. ✓ The sale of inventories after the reporting period may give evidence about their net realisable value at the end of the reporting period.

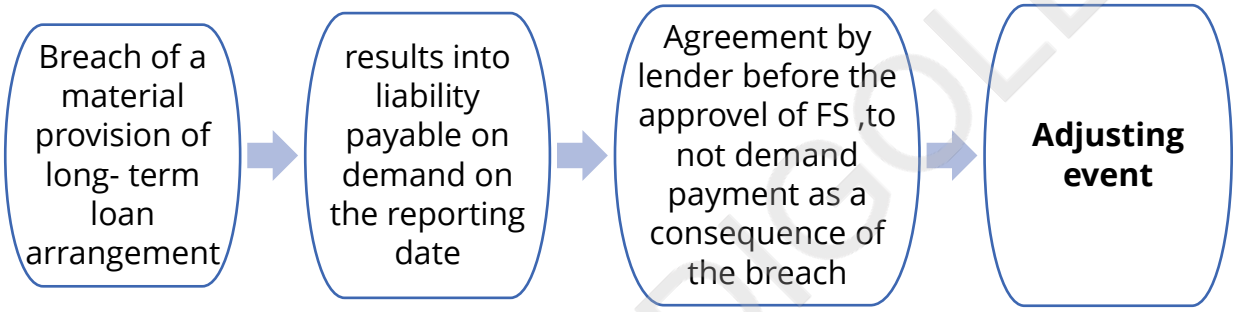
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	✓ The determination after the reporting period of the cost of assets purchased, or the proceeds from assets sold, before the end of the reporting period. ✓ The determination after the reporting period of the amount of **profit-sharing or bonus payments**
Non-Adjusting Events	✓ Decline in fair value of investment ✓ Declaration of dividend after the end of reporting period

5 Special Cases

5.1 Long-term Loan Arrangements

- Where there is a breach of a material provision of a long- term loan arrangement on or before the end of the reporting period with the effect that the liability becomes payable on demand on the reporting date,
- The agreement by lender before the approval of the financial statements for issue, **to not demand payment** as a consequence of the breach,
- Shall be considered as an **adjusting event**.
- In such cases, the long term loans would be classified as non-current



5.2 Going Concern

- An entity shall not prepare its financial statements on a going concern basis if management determines after the reporting period
  - either that it intends to liquidate the entity **or**
  - to cease trading **or**
  - that it has no realistic alternative but to do so.

- Deterioration in operating results and financial position after the reporting period may indicate a need to consider whether the going concern assumption is still appropriate.

6 Dividends

- If an entity declares dividends to holders of equity instruments after the reporting period, the entity shall not recognise those dividends as a liability at the end of the reporting period.
- Such dividends are disclosed in the notes in accordance with Ind AS 1, Presentation of Financial Statements.

7 Disclosures

- Approvals,
  - Date of approval?
  - Who approved?
  - Do owners or others have power to amend the financial statements?

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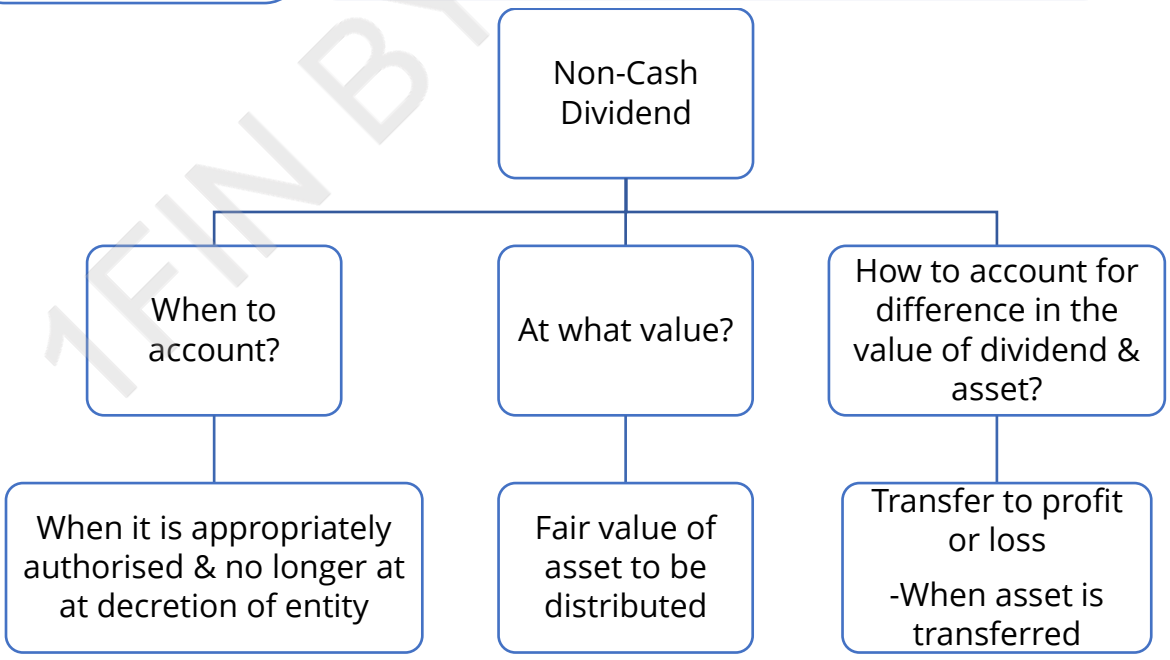
- Updating disclosure about conditions at the end of the reporting period
- Material Non-adjusting events,
    - Nature of the event.
    - An estimate of the financial effect or a disclosure that an estimate cannot be made.

Examples of Material Non-adjusting events:

1) A major business combination after the reporting period
2) Announcing a plan to discontinue an operation
3) Major purchases of assets, classification of assets as held for sale
4) The destruction of a major production plant by a fire after the reporting period
5) Announcing, or commencing the implementation of, a major restructuring
6) Major ordinary share transactions and potential ordinary share transactions after the reporting period
7) Abnormally large changes after the reporting period in asset prices or foreign exchange rates
8) Changes in tax rates or tax laws
9) Entering into significant commitments or contingent liabilities
10) Commencing major litigation arising solely out of events that occurred after the reporting period.

8 Distribution of Non-Cash Assets to Owners (Appendix A to Ind AS 10)

Applicability of Ind AS 10	• Distributions of non-cash assets • Distributions that give owners a choice of receiving either non-cash assets or a cash alternative
Non-applicability of Ind AS 10	• Does not apply to Distribution of a non-cash asset that is ultimately controlled by the same party or parties before and after the distribution.



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8.1 Journal Entries

a) On the date of declaration of dividend

Particulars		Debit	Credit
Retained Earnings	Dr.	XXXX*	
To Dividend Payable			XXXX*

*At the fair value of asset to be distributed

b) On distribution of asset as dividend

Particulars		Debit	Credit
Dividend Payable	Dr.	XXXX	
To PPE			XXXX

At the end of each reporting period and on the date of settlement

- Entity to review and adjust carrying amount of dividend payable,
- with any changes in carrying amount of dividend payable recognised as adjustment to retained earnings**.**

8.2 Appendix A – Disclosures

➢ An entity shall disclose the following information, if applicable:

- carrying amount of the dividend payable at the beginning and end of the period;
- increase or decrease in the carrying amount recognised in the period as result of a change in the fair value of the assets to be distributed.

➢ If after the end of a reporting period but before the financial statements are approved for issue, an entity declares a dividend to distribute a non-cash asset, it shall disclose:

- the nature of the asset to be distributed;
- the carrying amount of the asset to be distributed as of the end of the reporting period and
- the fair value of the asset to be distributed as of the end of the reporting period, if it is different from its carrying amount.

9 Significant difference between Ind AS 10 and AS 4

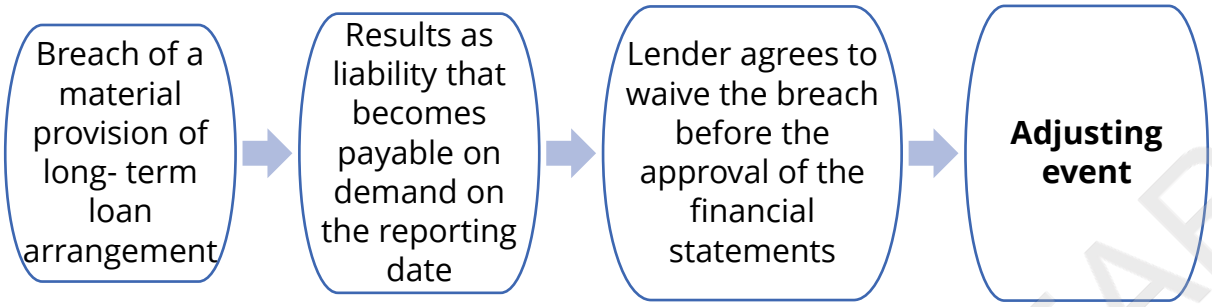
Basis of differences	IND AS 10: Events after the Reporting Period	AS 4- Contingencies and Events Occurring After the Balance Sheet Date
Material non-Adjusting events	To be disclosed in financial statements	To be disclosed in report of approving authority
Breach of a material provision of a long-term loan arrangement	Provide guidance under definition of "Events after the reporting period"	No guidance
Distribution of non-cash assets to owners	Includes Appendix A - Distribution of Non-cash Assets to owners	No guidance

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10 Carve Out in Ind AS 10 from IAS 10

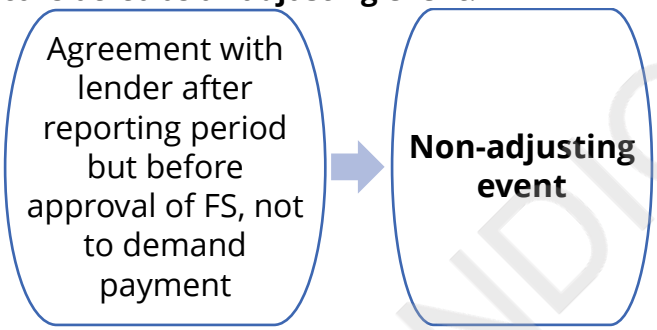
10.1 Ind AS 10 Carve Out

- In case of breach of a material provision of a long-term loan arrangement on or before the end of the reporting period
- such liability becomes payable on demand on the reporting date
- if the lender, before the approval of the financial statements for issue, agrees to waive the breach,
- it shall be considered as an **adjusting event**.



10.2 IAS 10

- An agreement with the lender after the reporting period but before the approval of the financial statements for issue, not to demand payment
- is **not** considered as an **adjusting event**.



ILLUSTRATIONS

1. Illustration

ABC Ltd. prepared interim financial report for the quarter ending 30th June, 20X1. The interim financial report was approved for issue by the Board of Directors on 15th July, 20X1. Whether events occurring between end of the interim financial report and date of approval by Board of Directors, i.e., events between 1st July, 20X1 and 15th July, 20X1 that provide evidence of conditions that existed at the end of the interim reporting period shall be adjusted in the interim financial report ending 30th June, 20X1? (SM)

[Ans: Yes, they should be adjusted. Reporting period implies any term for which reporting is done by preparing financial statements]

2. Illustration

The Board of Directors of ABC Ltd. approved the financial statements for the reporting period 20X1-20X2 for issue on 15th June, 20X2. The management of ABC Ltd. discovered a major fraud and decided to reopen the books of account. The financial statements were subsequently approved by the Board of Directors on 30th June, 20X2. What is the date of approval for issue as per Ind AS 10 in the given case? (SM)
[Ans: 30th June, 20X2]

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3. Illustration

A case is going on between ABC Ltd., and GST department on claiming some exemption for the year 20X1-20X2. The court has issued the order on 15th April, 20X2 and rejected the claim of the company. Accordingly, the company is liable to pay the additional tax. The financial statements of the company for the year 20X1-20X2 have been approved on 15th May, 20X2. Should the company account for such tax in the year 20X1-20X2 or should it account for the same in the year 20X2-20X3? (SM)
[Ans: 20X1-20X2]

4. Illustration

While preparing its financial statements for the year ended 31st March, 20X1, XYZ Ltd. made a general provision for bad debts @ 5% of its debtors. In the last week of February, 20X1 a debtor for Rs. 2 lakhs had suffered heavy loss due to an earthquake; the loss was not covered by any insurance policy. Considering the event of earthquake, XYZ Ltd. made a provision @ 50% of the amount receivable from that debtor apart from the general provision of 5% on remaining debtors. In April, 20X1 the debtor became bankrupt. Can XYZ Ltd. provide for the full loss arising out of insolvency of the debtor in the financial statements for the year ended 31st March, 20X1?

Would answer be different if earthquake had taken place after 31st March, 20X1, and therefore, XYZ Ltd. did not make any specific provision in context that debtor and made only general provision for bad debts @ 5% on total debtors? (SM)

[Ans: Yes, it should provide for full loss. If earthquake had taken place after end of reporting period, it will be non-adjusting event – in that case, if it's material, disclosures may be required]

5. Illustration

A company has inventory of 100 finished cars on 31st March, 20X2, which are having a cost of Rs. 4,00,000 each. On 30th April, 20X2, as per the new government rules, higher road tax and penalties are to be paid by the buyers for such cars (which were already expected to come) and hence the selling price of a car has come down and the demand for such cars has dropped drastically. The selling price has come down to Rs. 3,00,000 each. The financial statements of the company for the year 20X1-20X2 are not yet approved. Should the company value its stock at Rs. 4,00,000 each or should it value at Rs. 3,00,000 each? Ignore estimated costs necessary to make the sale. (SM)
[Ans: Rs. 3,00,000 – Events after reporting period provide evidence about net realisable value of cars at end of reporting period]

6. Illustration

ABC Ltd. has purchased a new machinery during the year 20X1-20X2. The asset was finally installed and made ready for use on 15th March, 20X2. However, the company involved in installation and training, which was also the supplier, has not yet submitted the final bills for the same.
The supplier company sent the bills on 10th April, 20X2, when the financial statements were not yet approved. Should the company adjust the amount of capitalisation in the year 20X1-20X2 or in the year 20X2-20X3? (SM)
[Ans: In year 20X1-20X2]

7. Illustration

Company XYZ Ltd. was formed to secure the tenders floated by a telecom company for publication of telephone directories. It bagged the tender for publishing directories for Pune circle for 5 years. It has made a profit in 20X1- 20X2, 20X2-20X3, 20X3-20X4 and 20X4-20X5. It bid in tenders for publication of directories for other circles – Nagpur, Nashik, Mumbai, Hyderabad but as per the results declared on 23rd April, 20X5, the company failed to bag any of these. Its only activity till date is publication of Pune directory.

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The contract for publication of directories for Pune will expire on 31st December 20X5. The financial statements for the F.Y. 20X4-20X5 have been approved by Board of Directors on 10th July, 20X5. Whether it is appropriate to prepare financial statements on going concern basis? (SM)
[Ans: It may not be appropriate – entity's operations are expected to come to end by 31st Dec 20X5]

8. Illustration

In the plant of PQR Ltd., there was a fire on 10th May, 20X1 in which the entire plant was damaged and the loss of Rs. 40,00,000 is estimated. The claim with the insurance company has been filed and a recovery of Rs. 27,00,000 is expected. The financial statements for the year ending 31st March, 20X1 were approved by the Board of Directors on 12th June, 20X1. Show how should it be disclosed? (SM)
[Ans: It's non-adjusting event; disclosures regarding material non-adjusting event should be made; company needs to determine whether it is appropriate to prepare the financial statements on going concern basis]

9. Illustration

ABC Ltd., has announced its interim results for Quarter 1, ending 30th June, 20X2 on 5th July, 20X2. However, till that time the AGM for the year 20X1-20X2 was not held. The financial statements for 20X1-20X2 were approved by the board of directors on 15th July, 20X2. What will be the 'after the reporting period' as per the definition given in Ind AS 10? (SM)
[Ans: Period between 31st Mar, 20X2 and 15th Jul, 20X2]

10. Illustration

ABC Ltd. is in a legal suit with the GST department. The company gets a court order in its favour on 15th April, 20X2, which resulted into reducing the tax liability as on 31st March, 20X2. The financial statements for 20X1-20X2 were approved by the board of directors on 15th May, 20X2. The management has not considered the effect of the transaction as the event is favourable to the company. The company's view is that favourable events after the reporting period should not be considered as it would hamper the realisation concept of accounting. Comment on the company's views in the light of Ind AS 10. (SM)
[Ans: Company's view is incorrect. Even favourable events need to be considered]

11. Illustration

ABC Ltd. is trading in laptops. On 31st March, 20X2, the company has 50 laptops which were purchased at Rs. 45,000 each. The company has considered the same price for calculation of closing inventory valuation. On 15th April, 20X2, advanced version of same series of laptops is introduced in the market. Therefore, the price of the current laptops crashes to Rs. 35,000 each. The financial statements for 20X1-20X2 were approved by the board of directors on 15th May, 20X2. The company does not want to value the stock at Rs. 35,000 less estimated costs necessary to make the sale as the event of reduction in selling price took place after 31st March, 20X2 and the reduced prices were not applicable as on 31st March, 20X2. Comment on the company's views. (SM)
[Ans:

12. Illustration

XY Ltd had taken a large-sized civil construction contract, for a public sector undertaking, valued at Rs. 200 Crores. Execution of the project started during 20X1-20X2, and continued in the next financial year also. During the course of execution of the work on 29th May, 20X2, the company found while raising the foundation work that it had met a rocky surface and cost of contract would go up by an extra Rs. 50 crore, which would not be recoverable from the Contractee as per the terms of the contract. The Company's financial year ended on 31st March, 20X2, and the financial statements were considered and approved by the Board of Directors on 15th June, 20X2. How will you treat the above in the financial statements for the year ended 31st March, 20X2? (SM)
[Ans: Cost of project and profit should be accounted considering extra Rs. 50 crore of cost]

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13. Illustration

A Ltd. was required to pay penalty for a breach in the performance of a contract. A Ltd. believed that the penalty was payable at a lower amount than the amount demanded by the other party. A Ltd. created provision for the penalty but also approached the arbitrator with a submission that the case may be dismissed with costs. A Ltd. prepared the financial statements for the year 20X1-20X2, which were approved in July 20X2. The arbitrator, in June 20X2, awarded the case in favour of A Ltd. As a result of the award of the arbitrator, the provision earlier made by A Ltd. was required to be reduced. The arbitrator also decided that cost of the case should be borne by the other party. Now, whether A Ltd. is required to remeasure its provision and what would be the accounting treatment of the cost that will be recovered by A Ltd., which has already been charged to the Statement of Profit and Loss as an expense for the year 20X1-20X2? (SM)

[Ans: Required to remeasure provision; Recovery of cost should be recognised in financial year 20X2-20X3]

14. Illustration

A company manufacturing and supplying process control equipment is entitled to duty drawback if it exceeds its turnover above a specified limit. To claim duty drawback, the company needs to file application within 15 days of meeting the specified turnover. If application is not filed within stipulated time, the Department has discretionary power of giving duty draw back credit. For the year 20X1-20X2, the company has exceeded the specified limit of turnover by the end of the reporting period but the application for duty drawback is filed on 20th April, 20X2, which is after the stipulated time of 15 days of meeting the turnover condition.

Duty drawback has been credited by the Department on 28th June, 20X2 and financial statements have been approved by the Board of Directors of the company on 26th July, 20X2. Whether duty drawback credit should be treated as an adjusting event? (SM)

[Ans: No, it is not an adjusting event. Duty draw back credit which was contingent asset for F.Y. 20X1-20X2 should be recognised as asset and related income should be recognised in reporting period in which change occurs. i.e., F.Y. 20X2-20X3.]

15. Illustration

XYZ Ltd. sells goods to its customer with a promise to give discount of 5% on list price of the goods provided that the payments are received from customer within 15 days. XYZ Ltd. sold goods of Rs. 5 lakhs to ABC Ltd. between 17th March, 20X2 and 31st March, 20X2. ABC Ltd. paid the dues by 15th April, 20X2 with respect to sales made between 17th March, 20X2 and 31st March, 20X2. Financial statements were approved for issue by Board of Directors on 31st May, 20X2.

State whether discount will be adjusted from the sales at the end of the reporting period. (SM)

[Ans: Yes. Condition that sales have been made exists at end of the reporting period, Receipt of payment within 15 days' time confirms that discount is to be provided on those sales]

16. Illustration

Whether the fraud related to 20X1-20X2 discovered after the end of the reporting period but before the date of approval of financial statements for 20X3-20X4 is an adjusting event? (SM)

[Ans: Yes. Condition was existing which has been confirmed by detection of same]

17. Illustration

X Ltd. was having investment in form of equity shares in another company as at the end of the reporting period, i.e., 31st March, 20X2. After the end of the reporting period but before the approval of the financial statements it has been found that value of investment was fraudulently inflated by committing a computation error. Whether such event should be adjusted in the financial statements for the year 20X1-20X2? (SM)

[Ans: Yes – Value of investments in financial statements should be adjusted for fraudulent error in the computation]

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18. Illustration

ABC Ltd. received a demand notice on 15th June, 20X2 for an additional amount of Rs. 28,00,000 from the Excise Department on account of higher excise duty levied by the Excise Department compared to the rate at which the company was creating provision and depositing the same in respect of transactions related to financial year 20X1-20X2. The financial statements for the year 20X1-20X2 are approved on 10th August, 20X2. In July, 20X2, the company has appealed against the demand of Rs. 28,00,000 and the company has expected that the demand would be settled at Rs. 15,00,000 only. Show how the above event will have a bearing on the financial statements for the year 20X1-20X2. Whether these events are adjusting or non-adjusting events and explain the treatment accordingly. (SM)

[Ans: It is an adjusting event. Company should make a provision in the financial statements for the year 20X1-20X2.]

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Ind AS 19
Employee Benefits

1 Objective

- to prescribe the ***accounting*** and ***disclosure*** for employee benefits.
- Ind AS 19 requires an entity to recognise:
  - a liability for advance services received from an employee; and
  - an expense for consumption of economic benefits raised from the service provided by an employee in exchange for employee benefits.

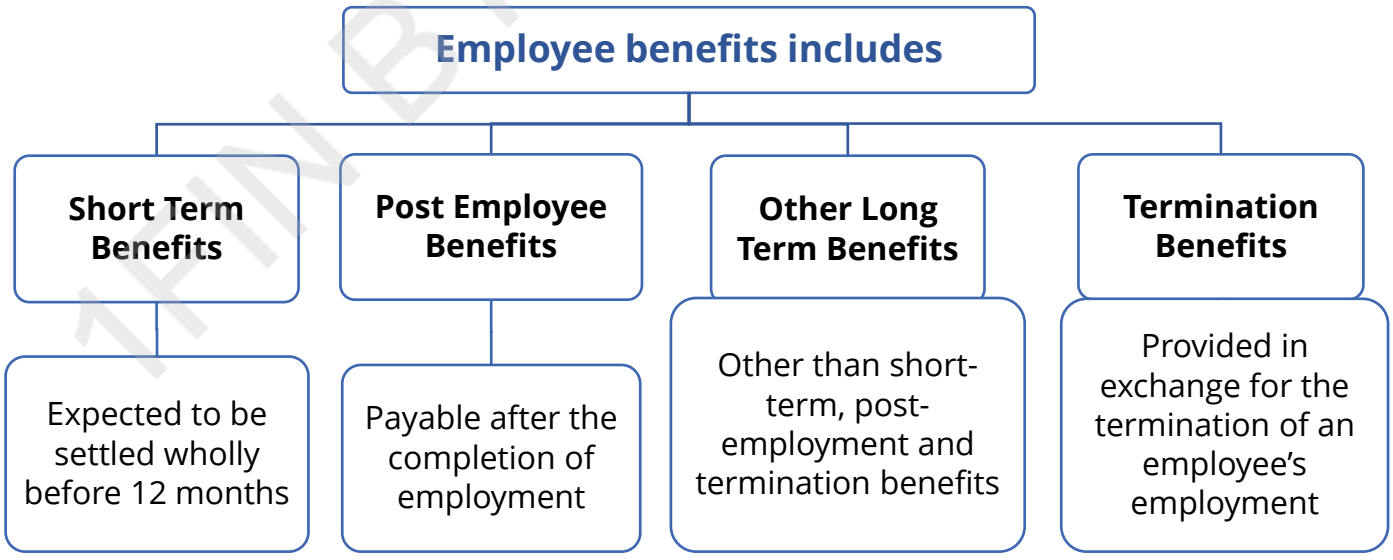
2 Scope

- The employee benefits to which this Standard applies include those provided:
  - under ***formal plans or other formal agreements*** between an entity and individual employees, groups of employees or their representatives;
  - under ***legislative requirements***, or through industry arrangements; or
  - by those ***informal practices*** that give rise to a constructive obligation.

- This Standard does not deal with reporting by employee benefit plans (e.g by provident fund trusts)
- This Standard shall be applied by an employer in accounting for all employee benefits, **except those to which Ind AS 102, Share-based Payment**, applies

3 Employee benefits

- ***Employee benefits*** means all forms of consideration given by an entity
  - in exchange for **service rendered** by employees or
  - for the t**ermination** of employment.



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Employee benefits Include benefits provided either to	Employee benefits may be settled by payments made either-	An employee may provide services to an entity on a-
employees; or	directly to the employees; or	full-time; or
their dependants; or	their spouses; or	part-time; or
their beneficiaries.	their children; or	permanent; or
	their other dependants; or	casual; or
	others, such as insurance companies	temporary basis.

4 Short term employee benefits

- Short-term employee benefits include items expected to be settled wholly before twelve months after the end of the annual reporting period in which the employees render the related services.

- Short term employee benefits include
  - wages, salaries and social security contributions;
  - paid annual leave and paid sick leave;
  - profit-sharing and bonuses; and
  - non-monetary benefits

- Reclassification of a short-term employee benefit is not required if the entity's expectations of the timing of settlement of such benefits changes temporarily.

4.1 Short-term paid absences

An employer may compensate an employee for absence for various reasons including holidays, sickness and short-term disability, maternity or paternity

Entitlement to paid absences fall into two categories as follows:

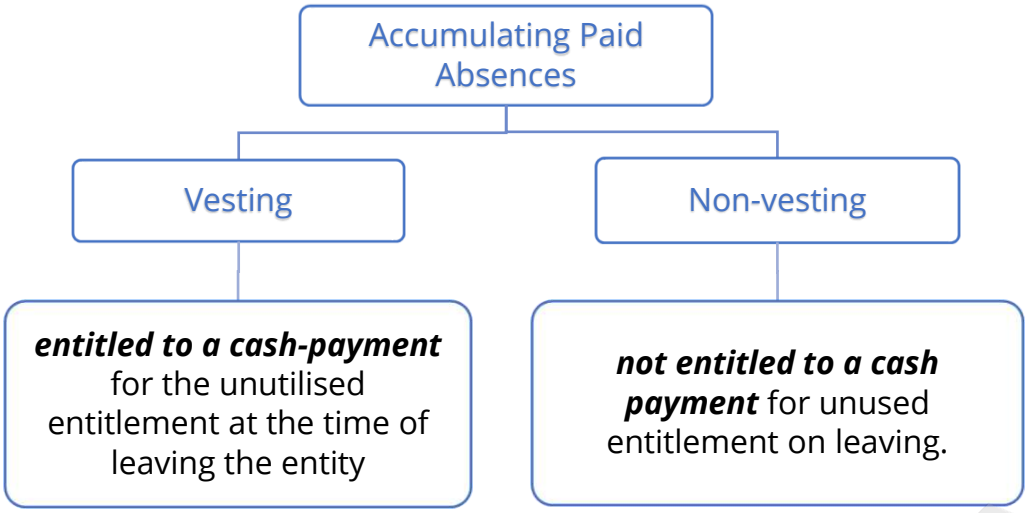
4.1.1 Non-accumulating Paid Absences

- These are the absences that ***do not carry forward*** and they will lapse if the current period's entitlement is not used in full by the employee.
- They do not entitle employees to a cash payment for unused entitlement on leaving the entity.
- No specific accounting treatment is needed.

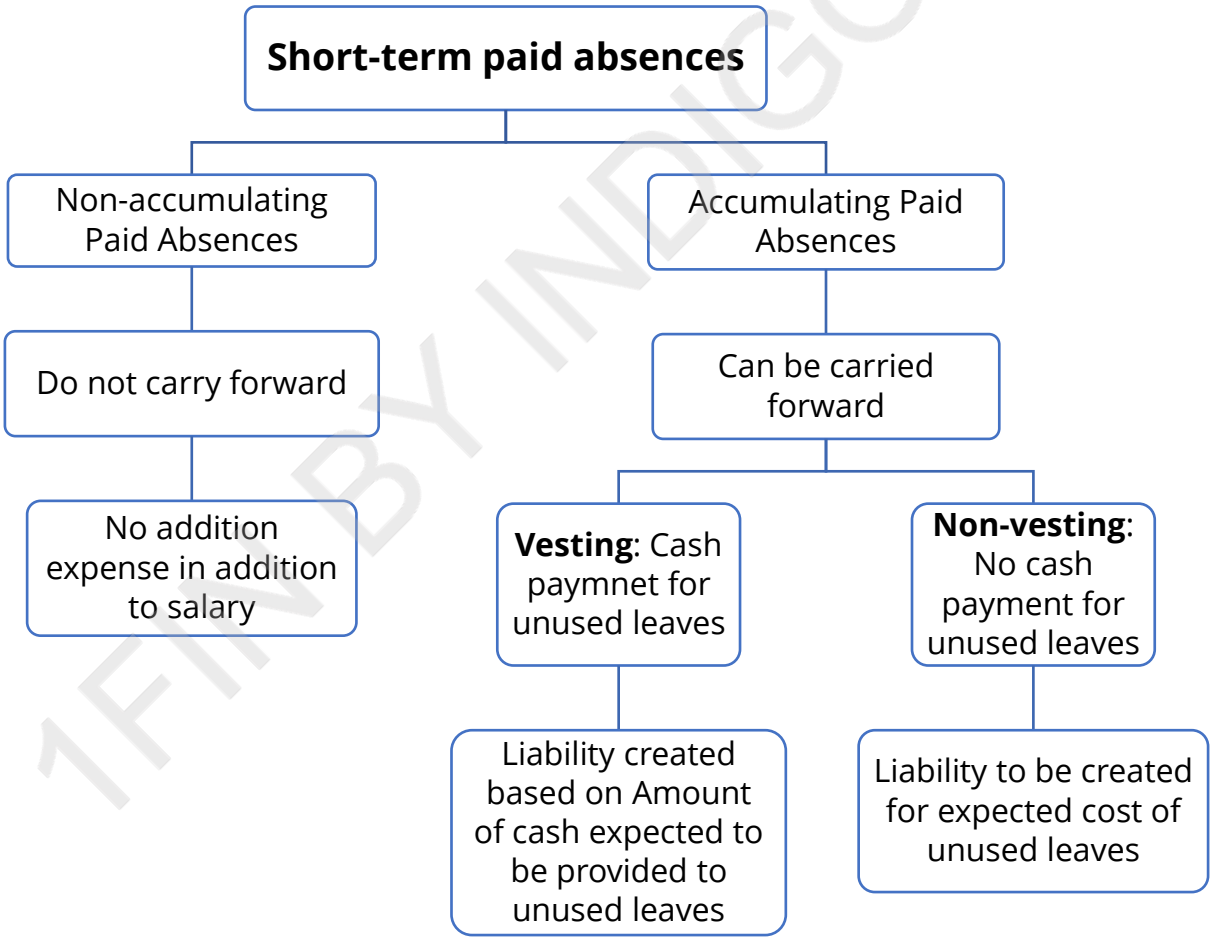
4.1.2 Accumulating Paid Absences

- These are the absences that are ***carried forward and can be used in future*** periods if the employee is not able to use them in current period.

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- An entity shall measure the expected cost of accumulating compensated absences as the **additional amount that the entity expects to pay as a result of the unused entitlement** that has accumulated at the end of the reporting period



4.2 Profit-sharing and Bonus Plans

- An entity may pay employees a percentage of profits as remuneration (generally called as bonus)

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- Expected costs of profit-sharing and bonus plans shall be recognised when,
  - the entity has a ***present obligation*** (legal or constructive) to make such payments as a result of past events; and
  - a ***reliable estimate*** of the obligation can be made by the entity.

- An obligation under profit-sharing and bonus plans results from employee service and not from a transaction with the entity's owners.
- An entity recognises the cost of profit-sharing and bonus plans not as a distribution of profit but as an expense.

4.3 Recognition and Measurement of Short-term Benefits

- Accounting for short term benefits has two characteristics:
  - Measured on an **undiscounted basis;** and
  - Do not require any actuarial valuation for their measurement.

- The undiscounted amount of short-term employee benefits expected to be paid in exchange for that service shall be recognised:
  - ***As a liability*** after deducting any amount already paid.
  - ***As an asset*** (if amount paid exceeds the undiscounted amount of the benefits for the period)
  - ***as an expense***, if it doesn't form part of the cost of an asset as per any other Ind AS.

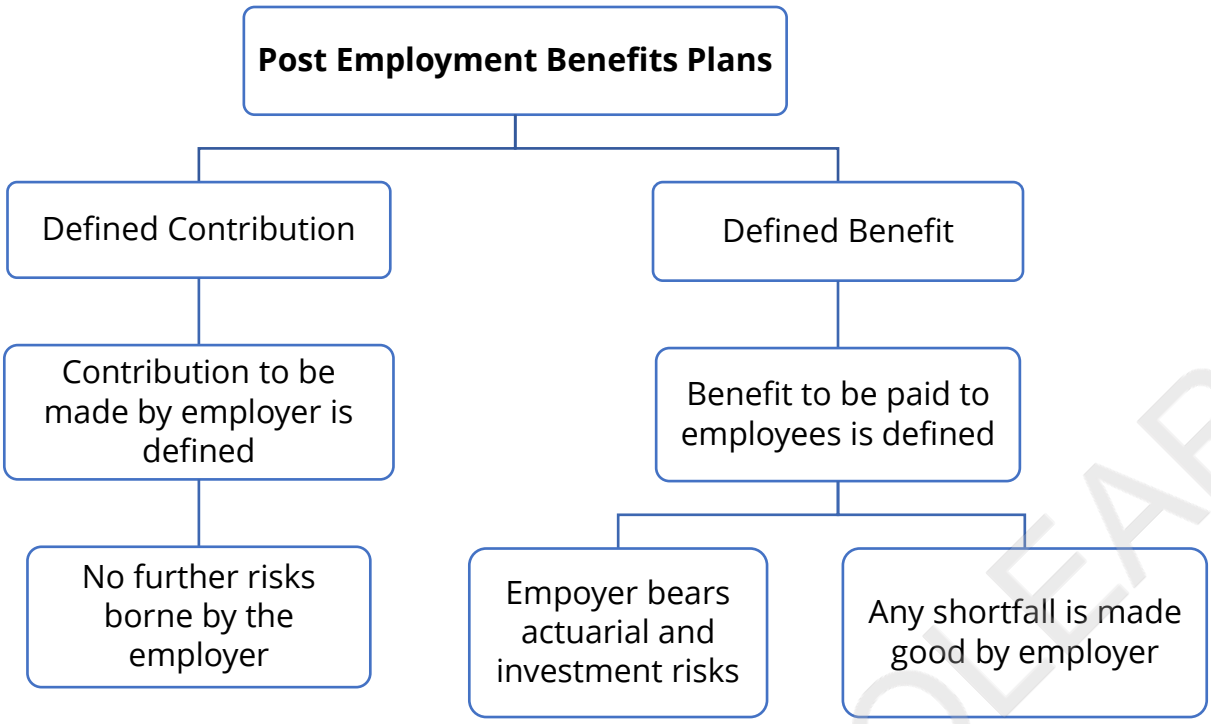
4.4 Disclosure of Short-term employee benefits

Ind AS 19	does not require specific disclosures
Other Ind AS	may require disclosures.
Examples	**Ind AS 24:** Requires disclosures about employee benefits for key management personnel **Ind AS 1:** Presentation of Financial Statements, requires disclosure of employee benefits expense.

5 Post-employment benefits

- Post-employment benefits include:
  - Retirement benefits such as pensions and lump sum payments on retirement
  - Other post-employment benefit such as post-employment life insurance and post-employment medical care.

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5.1 Defined contribution plans

- The entity's ***obligation*** (legal or constructive) is limited to the ***amount that it agrees*** to contribute to the fund**.**
- The amount of the post-employment benefits received by the employee is determined by the amount of contribution paid by an entity
- Under defined contribution plan
  - ***actuarial risk*** *(that benefits will cost more than expected)* and
  - ***investment risk*** *(assets invested will be insufficient to meet expected benefits)*
  - will fall on the ***employee***
- ***Discounting*** should be done if contribution is payable after ***12 months*** from reporting date

5.2 Defined Benefit plans

- The entity's ***obligation*** is to provide the ***agreed benefits (****Benefits are defined)* to current and former employees;
- The ***actuarial risk*** and ***investment risk*** fall on the ***entity***
- If actuarial or investment experience are worse than expected, the entity's obligation may be increased.

Differences

Particulars	Defined Contribution Plans	Defined Benefit Plans
Entity's obligation	Limited to the amount that it agrees to contribute to the fund.	To provide the agreed benefits to current and former employees.
Determination of the amount of post-	determined by the amount of contribution paid by an entity and employee + return on it	Pre-determined / as agreed

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employment benefit		
Risk bearer	Actuarial risk and investment risk fall on the employee	These risks fall on entity

5.3 Accounting for Defined Contribution Plans

- The reporting entity's obligation for each period is determined by the amounts to be contributed for that period.

Particulars	***Debit***	***Credit***
Compensation Expenses Dr. To Liability / Bank (Payable/Paid)	XXXX	 XXXX

- No actuarial assumptions are required to measure the obligation or the expense and there is no possibility of any actuarial gain or loss**.**
- The obligations are measured on an undiscounted basis, except where the obligation falls due after twelve months after the end of the annual reporting period

5.3.1 Recognition and measurement

- When an employee has rendered service to an entity during a period, the entity shall

Recognise the contribution payable to a defined contribution plan in exchange for that service		
As a liability (accrued expense), after deducting any contribution already paid	As an asset (prepaid expense) if contribution already paid under a defined contribution plan exceeds the contribution due for service before the end of the reporting period Asset to be recognised at the PV of any economic benefits available in the form of a ***cash refund*** or a ***reduction in future payments***	As an expense if not included in the cost of an asset as per other Ind AS

5.3.2 Disclosure

An entity shall disclose	the amount recognised as an expense for defined contribution plans.
	information about contributions to defined contribution plans for key management personnel (as per Ind AS 24).

5.4 Accounting for Defined Benefit Plans

Accounting for defined benefit plans is complex because -

- ***actuarial assumptions*** are required to measure the obligation and the expense;
- there is a possibility of ***actuarial gains and losses***;
- the obligations are measured on a discounted basis because they may be settled many years after the employees render the related service.

5.4.1 Recognition and measurement

- Defined benefit plans can be:
  - unfunded or
  - funded.

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- The payment of funded benefits when they **fall due depends** on
  - the financial position and the investment performance of the fund; and
  - an entity's ability to make good any shortfall in the fund's assets.
- The entity underwrites the actuarial and investment risks associated with the plan i.e. the entity assumes ultimate liability.
- The expense recognised for a defined benefit plan is not always equal to the amount of the contribution due for the period.

5.4.2 Actuarial Assumptions

- The benefit payable to beneficiaries depends on multiple factors (variables)
- Actuarial assumptions are an entity's best estimates of the variables that will determine the ultimate cost of providing post-employment benefits
- Actuarial assumptions shall be ***unbiased*** and ***mutually compatible***.

Actuarial assumptions comprise of

Demographic Assumptions	• Average age of employees • Mortality- during and after employment • Rate of employee turnover, disability & early retirement • Proportion of plan member with dependants • Length of service etc.
Financial Assumptions	• Discount rate • Future salary & benefit levels • Inflation rates • In case of medical benefits, future medical cost, including claim handling costs etc.

5.4.3 Discount rate

- The rate which is used to discount post-employment benefit obligations is determined by reference to ***market yields on government bonds*** at the end of the reporting period
- Subsidiaries, associates, joint ventures and branches domiciled outside India shall discount post-employment benefit obligations arising on account of post-employment benefit plans using the rate determined by reference to ***market yields*** at the end of the reporting period on ***high quality corporate bonds***

5.4.4 Defined Benefit Obligation (DBO)

Defined Benefit Obligation	Obligation under a defined benefit plan
PV of Defined Benefit Obligation	PV of obligation resulting from employee service in current and prior periods

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How to calculate DBO?

Particulars	*Amount (Rs.)*
Opening Balance- DBO	**XXXX**
(+) Current Service cost	XXXX
(+) Interest cost	XXXX
(+/-) Past Service Cost	XXXX
(+) Actuarial Loss	XXXX
(-) Actuarial Gain	XXXX
(-) Benefit Payment	XXXX
(-) Gain on Settlement	XXXX
(+) Loss on Settlement	XXXX
Closing balance- DBO	**XXXX**

5.4.5 Current service cost

Current service cost is an increase in present value of DBO resulting from employee service during the current period.

Increase in the present value *of defined benefit obligation:*

Particulars		***Debit***	***Credit***
Employee Benefit Cost A/c	Dr.	XXXX	
To Defined Benefit Obligation			XXXX

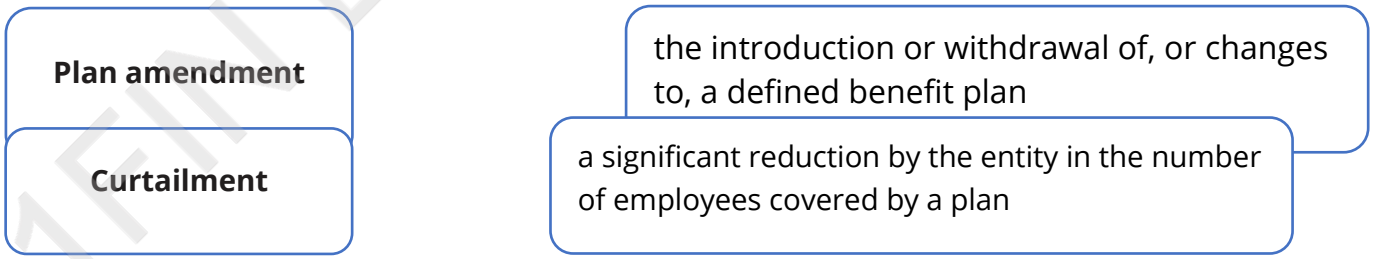
5.4.6 Interest Cost

Interest cost is the increase in DBO due to passage of time. Interest is computed by multiplying opening balance of DBO with the discount rate.

Particulars		***Debit***	***Credit***
Employee Benefit Cost A/c (Interest)	Dr.	XXXX	
To Defined Benefit Obligation			XXXX

5.4.7 Past service cost

Change in the present value of the defined benefit obligation for employee service in prior periods resulting from a ***plan amendment*** or ***curtailment*** is known as past service cost



- An entity shall recognise past service cost as an expense at the earlier of the following dates:
  - when the plan amendment or curtailment occurs; and
  - when the entity recognises related restructuring costs
- Past service cost may be,
  - ***Positive***- when benefits are introduced or changed so that the present value of the defined benefit obligation increases or
  - ***Negative***- when benefits are withdrawn or changed so that the present value of the defined benefit obligation decreases.

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***Increase in the present value** of defined benefit obligation:*

Particulars		Debit	Credit
Employee Benefit Cost A/c	Dr.	XXXX	
To Defined Benefit Obligation			XXXX

***Decrease in the present value** of defined benefit obligation:*

Particulars		Debit	Credit
Defined Benefit Obligation A/C	Dr.	XXXX	
To Employee Benefit Cost A/c			XXXX

5.4.8 Gain or loss on settlement

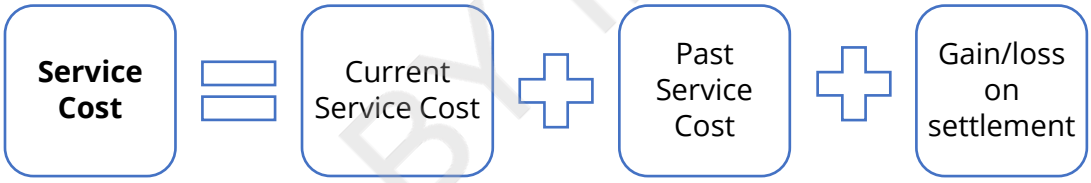
- A settlement occurs when an entity enters into a transaction that eliminates all further legal or constructive obligation for part or all of the benefits provided under a defined benefit plan
- The gain or loss on a settlement is the difference between:
  - the present value of the defined benefit obligation on the date of settlement; and
  - the settlement price.
- Gain or loss on the settlement of a defined benefit plan is recognised by the entity when the settlement occurs.

Loss on Settlement

Particulars		Debit	Credit
Employee Benefit Cost A/C	Dr.	XXXX	
To Defined benefit liability A/c			XXXX

Gain on Settlement

Particulars		Debit	Credit
Defined benefit liability A/C	Dr.	XXXX	
To Employee Benefit Cost A/C			XXXX



5.4.9 Actuarial gains and losses

- Actuarial gains and losses are changes in the present value of the defined benefit obligation resulting from:
  - experience adjustments (the effects of differences between the previous actuarial assumptions and what has actually occurred); and
  - the effects of changes in ***actuarial assumptions.***

Actuarial gain/loss will be recognised in ***Other Comprehensive Income***

Actuarial Loss

Particulars		Debit	Credit
Other Comprehensive Income A/c	Dr.	XXXX	
To Defined Benefit Liability A/C			XXXX

Actuarial Gain

Particulars	Debit	Credit

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Defined Benefit Liability A/C Dr. To Other Comprehensive Income A/c	XXXX	 XXXX

5.4.10 Benefit Payment

Payment of Employee benefits

Particulars	Debit	Credit
Defined Benefit Obligation A/C Dr. To Bank A/c	XXXX	 XXXX

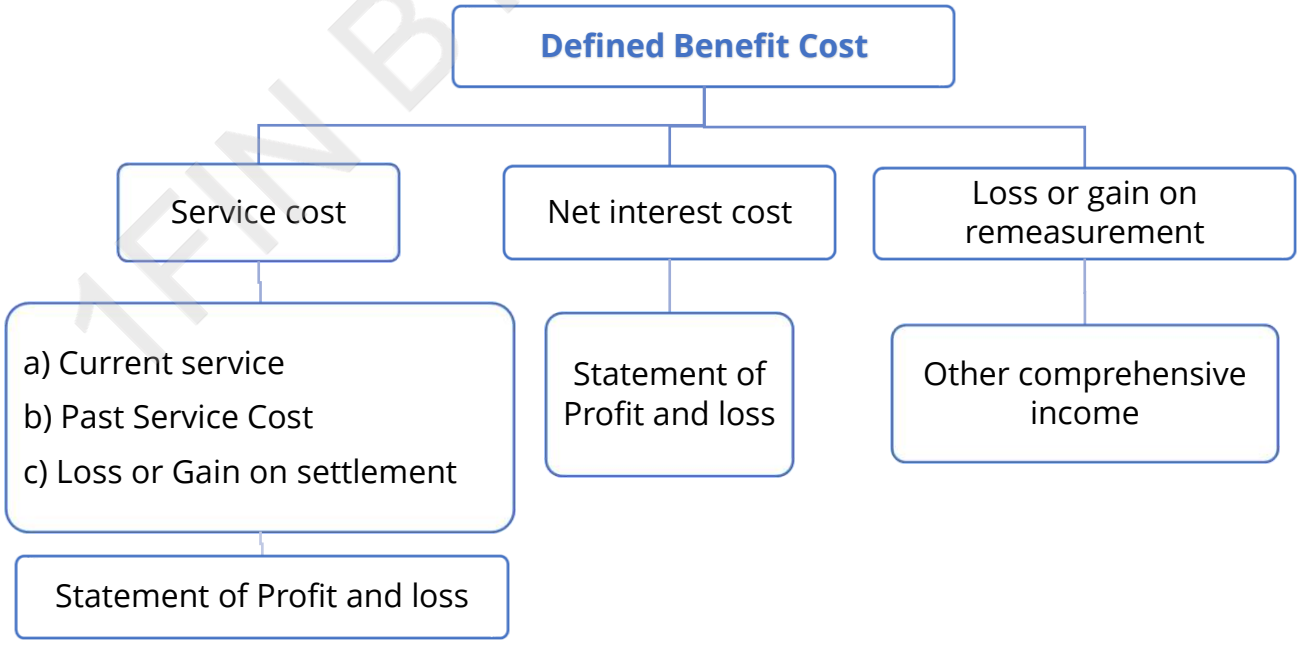
5.4.11 Steps involved in accounting by an entity for defined benefit plans

Determine the deficit or surplus	PUCM (Projected Unit Credit Method) Discounting Fair value of plan assets
Determine the amount of the net defined benefit liability (asset)	As the amount of the deficit or surplus
Determine the amounts to be recognised in Profit or Loss	Current service cost Past service cost Net interest
Determine the remeasurements of the net defined benefit liability (asset)	Actuarial Gain or Loss Return on Plan Assets Any Change in effect of Asset Ceiling

Projected Unit Credit Method (PUCM)

Each period of service as which rise to additional unit of benefit entitlement and measures each unit separately to build up final obligation

5.5 Components of Defined Benefit Cost



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5.6 Net interest on the net defined benefit liability (asset)

- The change during the period in the net defined benefit liability (asset) that arises from the passage of time
- An entity shall determine net interest on the net defined benefit liability (asset) by multiplying the net defined benefit liability (asset) by the discount rate.
- If an entity remeasures the net defined benefit plan (asset), the entity shall determine interest for the remainder of the annual reporting period after plan amendment.

5.7 Remeasurements of the net defined benefit liability (asset)

Remeasurements of the net defined benefit liability (asset) comprise:

- actuarial gains and losses;
- Actual Return – Expected Return
    - the return on plan assets, excluding amounts included in net interest on the net defined benefit liability (asset);
- any change in the effect of the asset ceiling, excluding amounts included in net interest on the net defined benefit liability (asset).

Recognise remeasure gain/loss in ***other comprehensive income***

Particulars	***Net Liability***
Opening Balance	XXXX
Add:	
Current Service cost	XXXX
Past Service Cost	XXXX
Net Finance Cost	XXXX
Loss on Settlement	XXXX
Less:	
Gain on Settlement Benefits Paid	**XXXX**
Expected Closing Balance	XXXX
Actual Closing Balance	XXXX
Gain/(Loss) on remeasurement	**XXXX**

6 Plan Assets

Plan assets comprise

a) assets held by a long-term employee benefit fund and
b) qualifying insurance policies

6.1 Assets held by a long-term employee benefit fund

Assets (other than non-transferable financial instruments issued by the reporting entity) that:

- are held by an entity (a fund) that is legally separate from the reporting entity and exists solely to pay or fund employee benefits; and
- are available to be used only to pay or fund employee benefits, are not available to the reporting entity's own creditors (even in bankruptcy), and cannot be returned to the reporting entity, ***unless either:***
    i. the remaining assets of the fund are sufficient to meet all the related employee benefit obligations of the plan or the reporting entity; or

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ii. the assets are returned to the reporting entity to reimburse it for employee benefits already paid.

6.2 Qualifying insurance policies

- Insurance policy issued by an insurer that is not a related party of the reporting entity
- if the proceeds of the policy:
  a) can be used only to pay or fund employee benefits under a defined benefit plan; and
  b) are not available to the reporting entity's own creditors (even in bankruptcy) and cannot be paid to the reporting entity, ***unless either***:
     i. the proceeds represent surplus assets that are not needed for the policy to meet all the related employee benefit obligations; or
     ii. the proceeds are returned to the reporting entity to reimburse it for employee benefits already paid.

Contribution by an employer to the fund

Particulars	***Debit***	***Credit***
Plan Asset A/C Dr.	XXXX	
To Bank A/c		XXXX

Payments to employees by the fund

Particulars	***Debit***	***Credit***
Employee Benefit Obligation A/C Dr.	XXXX	
To Plan Asset A/c		XXXX

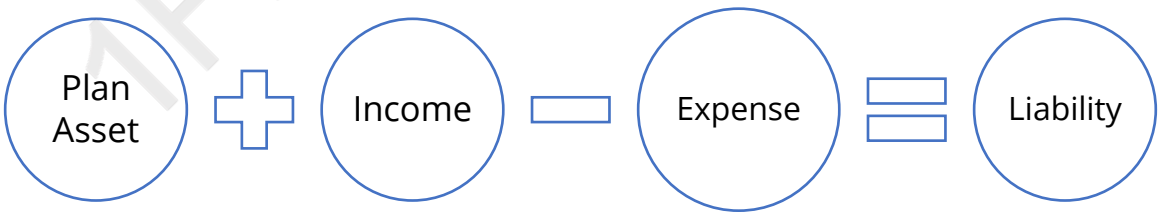
6.3 Return on plan assets

Interest, dividends and other income derived from the plan assets, together with realised and unrealised gains or losses on the plan assets, less:

- any costs of managing plan assets; and
- any tax payable by the plan itself, other than tax included in the actuarial assumptions used to measure the present value of the defined benefit obligation.

Return on plan assets

Particulars	***Debit***	***Credit***
Plan Asset A/C Dr.	XXXX	
To Employee Benefit Cost A/c		XXXX



6.4 Deficit or surplus in benefit plan

PV of DBO > Fair value of Plan Assets	Deficit	→	Net liability
PV of DBO > Fair value of Plan Assets	Surplus	→	Net Asset

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Asset > Obligation	Overfunded plan
Asset < Obligation	Underfunded plan

Asset ceiling: PV of any economic benefits available in the form of a ***refunds from the plan*** *or* a ***reduction in future contributions to plan***

An entity shall recognise the net defined benefit liability (asset) in the balance sheet at Lower of

- the surplus in the defined benefit plan; and
- the asset ceiling, determined using the discount rate

6.5 Net defined benefit liability (asset)

The deficit or surplus, adjusted for any effect of limiting a net defined benefit asset to the asset ceiling

7 Types of Defined Benefit Plan / Defined Contribution Plan

7.1 State Plan

- Established by legislation
- Operated by government (CG/SG/Autonomous)

Examples

- Statutory Provident Fund
- National Pension Scheme

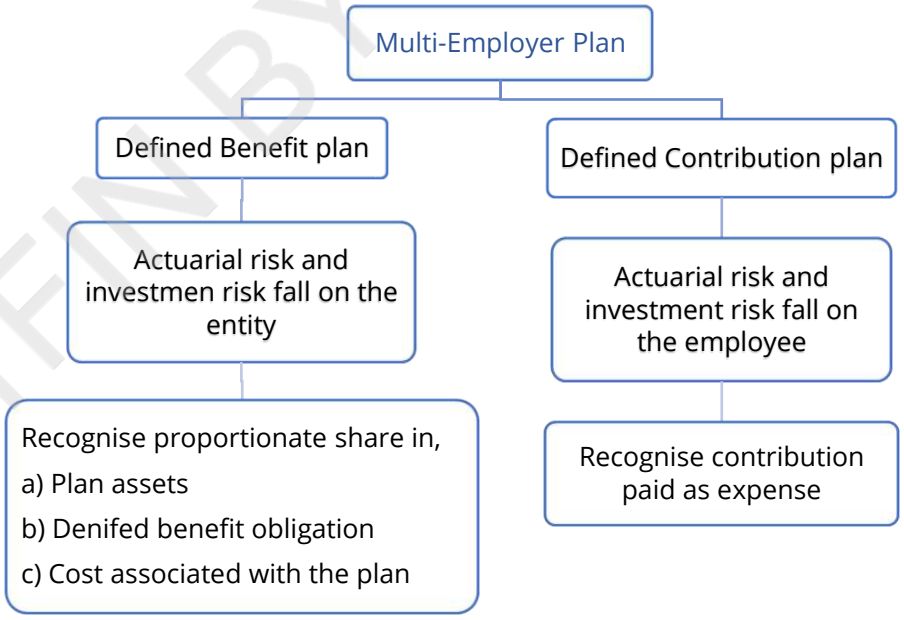
Generally, State plans are defined contribution plans

7.2 Multi-Employer Plan

Plans **other than** state plans

- Pool of assets are contributed by various entities that are ***not under common control***
- Use those assets to provide benefits to employees of ***more than one entity,*** on the basis that contributions and benefits are determined without regard to ***the identity of the entity*** that employs the employees

7.3 Accounting for Multi-Employer Plan



- Sufficient ***information*** is ***not available*** to use defined benefit accounting, account for the plan as if it were a defined contribution plan

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7.4 Group Administration Plan

- Aggregation of single employer plans combined to allow participating employers to pool their assets for investment purposes
- Reduce investment management and administration costs.
- Group administration plans are classified as a defined contribution plan or a defined benefit plan in accordance with the terms of the plan

7.5 Defined Benefit Plans that Share Risks between Entities under Common Control

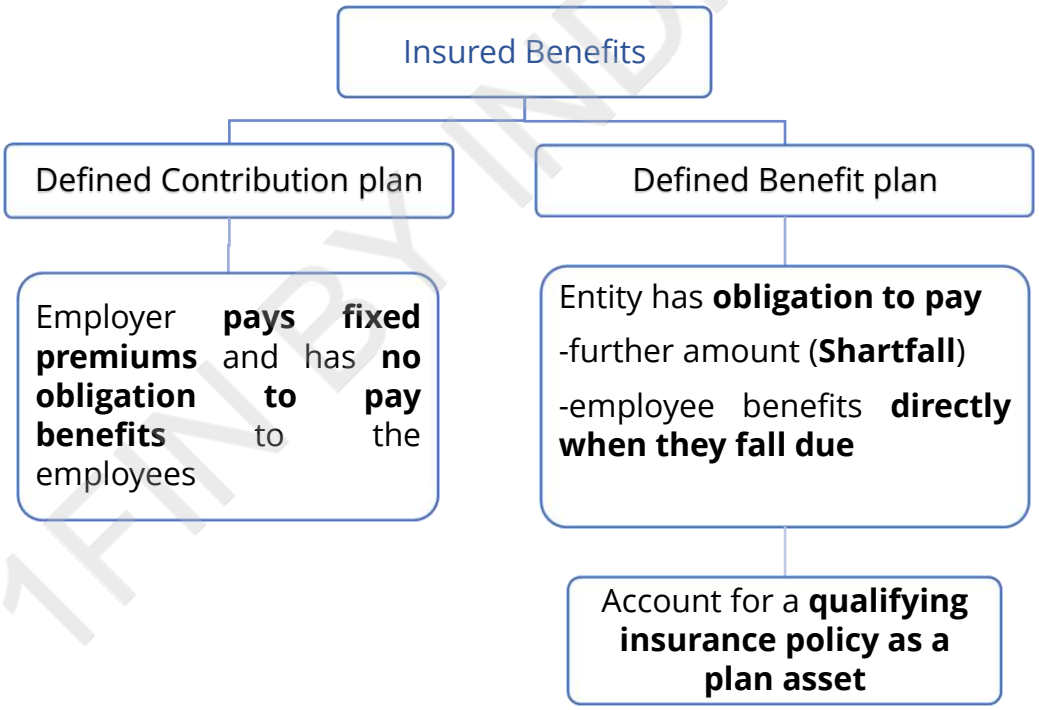
7.5.1 For Defined Benefit plan

Particulars	***Debit***	***Credit***
Employee benefit cost A/C Dr.	XXXX	
To Contribution Payable A/c		XXXX

7.5.2 For Defined Contribution plan

There is a contractual agreement	Recognise cost in the statement of Profit and loss in individual financial statements
If no such agreement	➢ Recognise cost in financial statements of sponsoring employer for the plan (group entity) ➢ Other group entities recognise cost equal to contribution payable

7.6 Insured Benefits



8 Presentation of Post-Employment Benefits.

8.1 Offset

An asset relating to one plan will be offset against a liability relating to another plan when, and only when, the entity:

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- has a ***legally enforceable right*** to use a surplus in one plan to settle obligations under the other plan; and
- there is ***an intention*** either to settle the obligations on a net basis, or to realise the surplus in one plan and settle its obligation under the other plan simultaneously.

8.2 Current/Non-current

Ind AS 19 does not specify whether an entity should distinguish current and non-current portions of assets and liabilities arising from post-employment benefits.

9 Disclosures

9.1 Disclosures of Defined Benefit plan

An entity shall disclose information that:

a) explains the characteristics of its defined benefit plans and risks associated with them;
b) identifies and explains the amounts in its financial statements arising from its defined benefit plans; and
c) describes how its defined benefit plans may affect the amount, timing and uncertainty of the entity's future cash flows.

9.2 Disclosures of Multi-employer plans

If an entity participates in a multi-employer defined benefit plan, it shall disclose:

a) a description of the funding arrangements, including the method used to determine the entity's rate of contributions and any minimum funding requirements;
b) a description of the extent to which the entity can be liable to the plan for other entities' obligations under the terms and conditions of the multi-employer plan;
c) a description of any agreed allocation of a deficit or surplus on:
    i. the entity's withdrawal from the plan.
    ii. if wind-up of the plan; or
d) If the entity accounts for that plan as if it were a defined contribution plan in accordance with paragraph 34, it shall disclose the following,
    i. the fact that the plan is a defined benefit plan.
    ii. the reason why sufficient information is not available to enable the entity to account for the plan as a defined benefit plan.
    iii. the expected contributions to the plan for the next annual reporting period
    iv. information about any deficit or surplus in the plan that may affect the amount of future contributions,
    v. an indication of the level of participation of the entity in the plan compared with other participating entities.

9.3 Disclosures of Defined Benefit Plans that share risks between entities under common control

If an entity participates in a defined benefit plan that shares risks between entities under common control, it shall disclose:

a) the contractual agreement or stated policy for charging the net defined benefit cost or the fact that there is no such policy.
b) the policy for determining the contribution to be paid by the entity.
c) Disclosure of defined benefit cost (reconciliation etc) or defined contribution payable as applicable
d) Cross reference to another entity's financials statements can be done if the information about plan is available and group's entity financial statements are available

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10 Other Long Term Employee Benefits

Settlement	>12 months from the end of financial reporting period
Benefits	Other than ➢ Short-term employee benefits ➢ Post-Employee benefits ➢ Termination benefits
Example	➢ Long-term paid absences ➢ Jubilee/Long term service benefits ➢ Long-term disability benefits ➢ profit-sharing and bonus plan ➢ deferred remuneration.

10.1 Accounting for other long-term employee benefits

For other long-term employee benefits, an entity shall recognise the net total of the following amounts in profit or loss,

a) service cost;
b) net interest on the net defined benefit liability (asset); and
c) remeasurements of the net defined benefit liability (asset).

11 Termination benefits

Termination benefits result from either:

- an entity's decision to terminate the employment or
- an employee's decision to accept an offer of benefits in exchange for the termination of employment.

Termination benefits does not Include,

- Employee benefits resulting from termination of employment ***at the request of the employee without an entity's offer***
- as a result of mandatory retirement requirements

11.1 Recognition of termination benefits

- Recognise a liability and expense for termination benefits

Expected to be settled before 12 months	Apply the requirements for ***short-term*** employee benefits
Expected to be settled before 12 months	Apply the requirements for ***long-term*** employee benefits

- An entity is required to recognise a liability and expense for termination benefits at the ***earlier*** of the following dates:
  a) when the entity can no longer withdraw the offer of those benefits; and
  b) when the entity recognises costs for a restructuring which is within the scope of Ind AS 37 and involves the payment of termination benefits.

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12 Appendix B

Issues addressed are

a) Refund from a plan
b) Reduction in future contributions
c) Minimum funding requirement

Right to refund	➢ Available only if the entity has unconditional ***right to a refund*** ➢ The amount of refund is determined as the full amount or a proportion of the surplus → ***no adjustment for time value of money*** ➢ If the refund if fixed amount → ***consider time value of money***
Economic benefit available as a contribution reduction	➢ No minimum requirement ➢ Economic benefits → Reduction in future cost
Minimum funding requirement	The ***minimum amount*** or the level of contribution that ***must be given to a plan*** over the given period **Prepayment** → reduces future minimum funding requirement contributions

13 Significant differences between Ind AS 19 and AS 15

Basis of differences	IND AS 19	AS 15
Constructive Obligations	In Ind AS 19, employee benefits arising from constructive obligations are also covered	AS 15 does not deal with the same
Definition of Employee	Ind AS 19 the term 'employee' includes directors	As per AS 15, the term 'employee' includes whole-time directors
Other Definitions	Definitions of short-term employee benefits, other long-term employee benefits, and past service cost is different in Ind AS 19	Different definitions are given in AS 15
Contractual Agreement between a Multi-employer Plan and its Participants	Deals with contractual agreement	AS 15 does not deal with it
Participation in a Defined Benefit Plan Sharing Risks Between Various Entities under Common Control	Covered	Not covered
Recognition of Past Service Cost	Past service should be recognised immediately	Recognise past service cost as an expense on a **straight-**

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		line basis over the average period **until the benefits become vested.** To the extent that the **benefits are already vested** immediately following the introduction of, or changes to, a defined benefit plan, an enterprise should **recognise** past service cost **immediately**.
Frequency of Actuarial valuation	Ind AS 19 does not specify sufficient regularity	Detailed actuarial valuation to determine the PV of DBO Is carried out at least once every 3 years and fair value of plan assets are determined at each balance sheet date.
Recognition of Actuarial Gains and Losses	Shall be recognised in other **comprehensive income**	Recognise immediately in the statement of profit and loss
Financial Assumptions	shall be based on market expectations, at the end of the reporting period, for the period over which the obligations are to be settled	AS 15 does not clarify the same
Discounting of Post-employment Benefit Obligations	Special guidance on the discount rate for subsidiaries associates joint ventures and branches **domiciled outside India**	Rate used to for discounting should always be determined by **reference to** market yields at the balance sheet date on **government bond**.
Contribution from employee or third parties to defined benefit plans	Specific guidance under Ind AS 19	No specific guidance
Guidance on Interaction of Ceiling of Asset Recognition and Minimum Funding Requirement	Specific guidance under Ind AS 19	No specific guidance

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1. Illustration

Mr. Rajan is working for Infotech Ltd. Consider the following particulars:

Annual salary of Mr. Rajan = ₹ 30,00,000

Total working days in 20X0-X1 = 300 days

Leaves allowed in 20X0-X1 as per policy = 10 days

Leaves utilized by Mr. Rajan in 20X0-X1 = 8 days

The unutilized leaves are settled by way of payment and accordingly, carry forward of such leaves to the subsequent period is not allowed.

Compute the total employee benefit expense for Infotech Ltd. in respect of 20X0-X1.

2. Illustration

Mr. Niranjan is working for Infotech Ltd. Consider the following particulars:

	20X0-X1	20X1-X2
Annual salary	30,00,000	30,00,000
Working days	300 days	300 days
Leave allowed	10 days	10 days
Leave taken	7 days	13 days
Leave unutilized carried forward to next year	3 days	NIL

Scenario I

Based on past experience, Infotech Ltd. assumes that Mr. Niranjan will avail the unutilized leaves of 3 days of 20X0-20X1 in 20X1-20X2.

Infotech Ltd. contends that it will record Rs. 30,00,000 as employee benefits expense in each of the years 20X0-20X1 and 20X1-20X2, stating that the leaves will, in any case, be utilized by 20X1-20X2.

Comment on the accounting treatment proposed to be followed by Infotech Ltd. Also pass journal entries for both the years.

Scenario II

Based on past experience, Infotech Ltd. assumes that Mr. Niranjan will avail the unutilized leaves of 2 days of 20X0-20X1 subsequently. However, in 20X1-20X2, Mr. Niranjan availed in actual all 3 days of brought forward leave.

Compute the expense to be recognised in 20X0-20X1 and 20X1-20X2. Also pass journal entries for both the years.

3. Illustration

Sundaram Ltd. has a headcount of 100 employees in 20X0-20X1. As per the employee policy, the employees are entitled to:

- 30 casual leaves out of which 10 casual leaves may be carried forward to the next year; and
- 10 sick leaves out of which 2 sick leaves may be carried forward as paid leave.

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At 31st March, 20X1, the average unused entitlement is 5 days per employee for casual leaves and 1 day per employee for sick leave. On an average, it is found that the number of such employees who would be claiming casual leaves would be 30 and 10 employees who would claim sick leaves.

Compute the liability to be recognised in respect of sick leaves and casual leaves by the entity at the end of the financial year 20X0-20X1.

4. Illustration

An entity has 100 employees, who are each entitled to ten working days of paid sick leave for each year. Unused sick leave may be carried forward for one financial year. Sick leave is taken first out of the current year's entitlement and then out of any balance brought forward from the previous year (a LIFO basis).
At 31 March 20X1, the average unused entitlement is two days per employee. Based on past experience, the management expects that only 20% of the employees will use 1 day from their carried forward leave.
Salary per day is Rs. 2,500.
Compute the expenses in respect of the short-term compensated absences, if they are assumed to be
(a) vested short-term compensated absences, and
(b) non-vested short-term compensated absences.

5. Illustration

Acer Ltd. has 350 employees (same as a year ago). The average staff attrition rates observed during past 10 years represents 6% per annum. Acer Ltd. provides the following benefits to all its employees:
Paid vacation - 10 days per year regardless of date of hiring. Compensation for paid vacation is 100% of employee's salary and unused vacation can be carried forward for 1 year.
As of 31st March, 20X1, unused vacation carried forward was 3 days per employee, average salary was Rs. 15,000 per day and accrued expense for unused vacation in 20X0-20X1 was Rs. 65,00,000. During 20X1-20X2, employees took 9 days of vacation in average. Salary increase in 20X1-20X2 was 10%.
How would Acer Ltd. recognize liabilities and expenses for these benefits as of 31st March, 20X2?. Pass the journal entry to show the accounting treatment.

6. Illustration

An entity has 100 employees, who are each entitled to five working days of paid sick leaves for each year. Unused sick leave may be carried forward for one calendar year. Sick leave is taken first out of the current year's entitlement and then out of any balance brought forward from the previous year (LIFO basis).
At 31st March, 20X1, the average unused entitlement is two days per employee. The entity expects, on the basis of experience that is expected to continue, that 92 employees will take no more than five days of paid sick leaves in 20X1-20X2 and that the remaining eight employees will take an average of six and a half days each.
Would the entity require to recognize any liability in respect of leaves?

7. Illustration

Laxmi Mills is a profit-making entity and has reported profit of Rs.200 crore in the financial year 20X1-20X2. According to its profit–sharing plan, it distributes and pays 5% as its portion of profit to its employees if they complete 1 year with the organisation.
Under this plan, an entity is under an obligation to pay if the employees complete a specified period with the organisation. Laxmi Mills has estimated that due to staff turnover in the organisation, the estimated pay-out would be around 4.5%.
Compute the liability and expense of the company under this plan.

8. Illustration

Acer Ltd. has 350 employees (same as a year ago). The average staff attrition rates as observed during past 10 years represents 6% per annum. Acer provides the following benefits to all its employees:
Annual bonus - during past 10 years.

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Acer paid bonus to all employees who were in service during the entire financial year. Bonus was paid in June following the financial year-end. Amount of bonus for 20X1-20X2 paid in June 20X2 represented Rs. 1,25,000 per employee. Acer Ltd. used to increase amount of bonus based on official inflation rate which is 8.5% for 20X2-20X3, although there was no legal obligation to increase the bonus by such inflation rate. How would Acer Ltd. recognize liabilities and expenses for these employee benefits as on 31st March, 20X3? Pass the journal entry to show the accounting treatment.

9. Illustration

A company pays each employee a lump-sum one-time benefit upon retirement. This benefit is computed based on the employee's years in service in the company and the final salary prior to retirement. To cover its liabilities from this remuneration, the company contributes 3% of annual gross salaries to the fund. Would this obligation represent a defined contribution plan or a defined benefit plan and why?

10. Illustration

In accordance with applicable legislation, company contributes 12% and employees 12% of annual gross salaries to the provident and pension fund. Upon retirement, the employees will get the accumulated balance that is calculated based on employee's years of service and his average salary for past 15 years before retirement. The pension will be paid out of the state fund assets and the company has no further obligation except to make contributions. Would this obligation represent a defined contribution plan or a defined benefit plan?

11. Illustration

Acer Ltd. provides lump-sum remuneration upon retirement to its employees. Remuneration is paid out of the fund to which Acer Ltd. contributes 12% of annual gross salaries. Contributions are made twice a year i.e., in November of the related financial year and in June after the financial year- end. Total annual gross salaries for 20X0-X1 amounted to Rs. 50 crores. Contribution made by Acer Ltd. in November 20X0 was Rs. 2.8 crores. Remuneration depends on the number of employee's service and amount of cash in the fund at retirement date (Acer Ltd. has no further obligations except for contributions).

How should this transaction appear in the financial statements of Acer Ltd. as of 31 March 20X1?

12. Illustration

In 2017-18, Diana Ltd. has 3,000 employees in the company.
As per the company policy, the employees are given 30 days of Privilege Leave (PL), 12 days of Sick Leave (SL) and 12 days of Casual Leave. Out of the total PL and SL, 10 PL and 5 SL can be carried forward to next year. On the basis of past trends, it has been noted that 1,000 employees will take 5 days of PL and 2 days of SL and 2,000 employees will avail 10 as PL and 5 as SL.
Also, the company has been incurring profits since incorporation. It has been decided in 2017-18 to distribute profits to its employees @ 8% during the year. However, due to the employee turnover in the organisation, the expected pay-out of the Diana Ltd. is to be around 7%. The profits earned during 2017-18 is Rs. 12,000 lakh.
Diana Ltd. also has a post-employment benefit plan available which is in the nature of defined contribution plan where contribution to this fund amounts to Rs. 500 lakh which will fall due within 12 months from the end of accounting period. The company has paid Rs. 120 lakh to its employees in 2017-18. What is the treatment for the short-term compensating absences, profit-sharing plan and the defined contribution plan by Diana Ltd. as per the provisions of relevant Ind AS? [May 19 (N), 5 marks]

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13. Illustration

A company has an employee benefit plan which involves a lump sum payment to employee on termination of service and that is equal to 1 per cent of final salary for each year of service. Consider the salary in year 1 is Rs. 10,000 and is assumed to increase at 7 per cent (compound) each year.
Taking a discount rate at 10 per cent per year, you are required to show
(a) benefits attributed (year on year) and
(b) the obligation in respect of this benefit (year on year)
for an employee who is expected to leave at the end of year 5.

14. Illustration

A plan pays a lumpsum retirement benefit of Rs.4,000 to all employees who are still employed at the age of 55 after 20 years of service, or who are still employed at the age of 65, regardless of their length of service

15. Illustration

Amra Pvt. Ltd. Has a plan for its employees where it has decided to pay a lump sum benefit of Rs.2,000 that will vest after 10 years of service. However, that plan will provide no further benefit for subsequent service.
Compute the benefit attributed for 10 years of service and for the period of service after 10 years?

16. Illustration

Sanat Pvt. Ltd. Has a plan for employees where employees are entitled to benefit of 5% of final salary for each year of service before age of 55. Compute the benefit attributed up to 55 years and after 55?

17. Illustration

A post-employment medical plan reimburses 40% of an employee's post-employment medical costs if the employee leaves after more than 10 and less than 20 years of service and 50% of those costs if the employee leaves after 20 or more years of service. How will the benefit be attributed to the years of service?

18. Illustration

A post-employment medical plan reimburses 10% of an employee's post-employment medical costs if the employee leaves after more than 10 and less than 20 years of service and 50% of those costs if the employee leaves after 20 or more years of service. How will the benefit be attributed to the years of service?

19. Illustration

AKJ Ltd is a listed company engaged in the business of manufacturing of electronic equipment. The company has various branch offices spread out across India and has 1,000 employees.
As per the statutory requirements, gratuity shall be payable to an employee on the termination of his employment after he has rendered continuous service for not less than five years -

(a) on his superannuation, or
(b) on his retirement or resignation, or
(c) on his death or disablement due to accident or disease.

The completion of continuous service of five years shall not be necessary where the termination of the employment of any employee is due to death or disablement.
The amount payable is determined by a formula linked to number of years of service and last drawn salary.
The amount payable to an employee shall not exceed Rs.10,00,000.
How should the amount of employee benefit, if any, be attributed to each year of service?

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20. Illustration

OPQ Ltd is a listed company having its corporate office at Nagpur. The company has a branch office at Chennai. The company has been operating in Indian market for the last 10 years.

The company operates a pension plan that provides a pension of 2.5% of the final salary for each year of service. The benefits become vested after seven years of service.

On 1st April, 20X8, the company increased the pension to 3% of the final salary for each year of service starting from 1st April, 20X1. On the date of the improvement, the present value of the additional benefits for service from 1st April, 20X1 to 1 April 20X8 was as follows:

- Employees with more than seven years' service on 1 January 20X8 – Rs. 2,75,000
- Employees with less than 7 years of service – Rs. 2,21,000 (average 4 years to go)

What would be the accounting treatment in this case?

21. Illustration

RKA Private Ltd is an old company established in 19XX. The company started with a very small capital base and today it is one of the leading companies in India in its industry. The company has an annual turnover of Rs.11,000 crores and planning to get listed in the next year.

The company has a large employee base. The company provided a defined benefit plan to its employees. Following is the information relating to the balances of the fund's assets and liabilities as on 1st April X1 and 31st March X2 (Rs. Lacs)

Particulars	1st April	31st March
Present Value of benefit obligation	1,400	1,580
Fair Value of plans assets	1,140	1,275

For the financial year ended 31st March, 20X2, service cost was Rs. 55 lacs. The company made a contribution of an amount of Rs. 111 lacs to the plan. No benefits were paid during the year.

Consider a discount rate of 8%.

You are required to -

(a) Compute the balance(s) of the company to be included its balance sheet as on 31st March, 20X2 and amounts to be recognized in the statement of profit and loss and other comprehensive income for the year ended 31st March, 20X2.

(b) Give the journal entries in respect of amount(s) to be recognized.

22. Illustration

SA Pvt Ltd is engaged in the business of retail having 100 retail outlets across Northern and Southern India. The company's head office is located at Chennai.

SA Pvt Ltd is a subsidiary of SAG Ltd. SAG Ltd is listed on the National Stock Exchange in India.

Following information is available for SA Pvt Ltd:

Plan Assets

On 1st April, 20X1, the fair value of plan assets was ₹ 10,000.

Contribution to the plan assets done on 31st March, 20X2 – ₹ 3,000

Amount paid on 31st March, 20X2 – ₹ 300

On 31st March, 20X2, the fair value of plan assets was ₹ 14,700

Actual return on plan assets – ₹ 2,000

Defined Benefit Obligation

On 1st April, 20X1, present value of the defined benefit obligation was ₹ 12,000.

On 31st March, 20X2, present value of the defined benefit obligation was ₹ 15,500.

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Actuarial losses on the obligation for the year ended 31st March, 20X2 were ₹ 100.
Current Service Cost – ₹ 2,500
Benefit paid – ₹ 300
Discount rate used to calculate defined benefit liability - 10%.

As per Ind AS 19, please suggest if there is any amount based on the above-mentioned information that would be taken to other comprehensive income (with workings). Also compute net interest on the net defined benefit liability (asset).

23. Illustration

A Ltd. prepares its financial statements to 31st March each year. It operates a defined benefit retirement benefits plan on behalf of current and former employees. A Ltd. receives advice from actuaries regarding contribution levels and overall liabilities of the plan to pay benefits. On 1st April, 20X1, the actuaries advised that the present value of the defined benefit obligation was ₹ 6,00,00,000. On the same date, the fair value of the assets of the defined benefit plan was ₹ 5,20,00,000. On 1st April, 20X1, the annual market yield on government bonds was 5%. During the year ended 31st March, 20X2, A Ltd. made contributions of ₹ 70,00,000 into the plan and the plan paid out benefits of ₹ 42,00,000 to retired members. Both these payments were made on 31st March, 20X2.
The actuaries advised that the current service cost for the year ended 31st March, 20X2 was ₹ 62,00,000. On 28th February, 20X2, the rules of the plan were amended with retrospective effect. These amendments meant that the present value of the defined benefit obligation was increased by ₹ 15,00,000 from that date.
During the year ended 31st March, 20X2, A Ltd. was in negotiation with employee representatives regarding planned redundancies. The negotiations were completed shortly before the year end and redundancy packages were agreed. The impact of these redundancies was to reduce the present value of the defined benefit obligation by ₹ 80,00,000. Before 31st March, 20X2, A Ltd. made payments of ₹ 75,00,000 to the employees affected by the redundancies in compensation for the curtailment of their benefits. These payments were made out of the assets of the retirement benefits plan.
On 31st March, 20X2, the actuaries advised that the present value of the defined benefit obligation was ₹ 6,80,00,000. On the same date, the fair value of the assets of the defined benefit plan were ₹ 5,60,00,000.
Examine and present how the above event would be reported in the financial statements of A Ltd. for the year ended 31st March, 20X2 as per Ind AS. Finance cost is to be computed on the opening balances.

24. Illustration

On 1 April 20X1, the fair value of the assets of XYZ Ltd's defined benefit plan were valued at ₹ 20,40,000 and the present value of the defined obligation was ₹ 21,25,000. On 31st March,20X2 the plan received contributions from XYZ Ltd amounting to ₹ 4,25,000 and paid out benefits of ₹ 2,55,000. The current service cost for the financial year ending 31 March 20X2 is ₹ 5,10,000. An interest rate of 5% is to be applied to the plan assets and obligations. The fair value of the plan's assets at 31 March 20X2 was ₹ 23,80,000, and the present value of the defined benefit obligation was ₹ 27,20,000.
Provide a reconciliation from the opening balance to the closing balance for Plan assets and Defined benefit obligation. Also show how much amount should be recognised in the statement of profit and loss, other comprehensive income and balance sheet?

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Ind AS 33
Earning Per Share

1. Introduction

1.1 Objective

- To prescribe principles for the determination and presentation of earning per share.
- To facilitate performance comparisions between different entities in the same reporting period and between different reporting periods for the same entity.

Earnings per share data, may have limitations because of different accounting policies that companies might have used for determining 'earnings'.

1.2 Scope

- This standard requires that if an entity computes earnings per share then it must calculate and disclose the same as per this standard.
- EPS related information to be disclosed both in consolidated financial statements and separate financial statements.

Type of Financial statements	EPS disclosure	EPS computation should be based on
Consolidated	Yes	Information given in consolidated financial statements only (Consolidated EPS)
Separate	Yes	Information given in separate financial statements only (Separate EPS)

2. Definitions

2.1 Ordinary share (Referred to as equity shares in India)

An ordinary share is an equity instrument that is subordinate to all other classes of equity instruments.

- An entity may have more than one class of ordinary shares.
- Ordinary shares of the same class have the same rights to receive dividends.

2.2 Potential ordinary share

A potential ordinary share is a financial instrument or other contract that may entitle its holder to ordinary shares.

Examples of potential ordinary shares are:

a. Financial liabilities or equity instruments, including preference shares, that are convertible into ordinary shares;
b. Options and warrants;
c. Shares that would be issued upon the satisfaction of conditions resulting from contractual arrangements, such as the purchase of a business or other assets.

2.3 Options, warrants and their equivalents

Options, warrants and their equivalents are financial instruments that give the holder the right to purchase ordinary shares.

2.4 Put options

Put options on ordinary shares are contracts that give the holder the right to sell ordinary shares at a specified price for a given period.

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2.5 Dilution

Dilution is a reduction in earnings per share or an increase in loss per share resulting from the assumption that convertible instruments are converted, that options or warrants are exercised, or that ordinary shares are issued upon the satisfaction of specified conditions.

2.6 Antidilution

Antidilution is an increase in earnings per share or a reduction in loss per share resulting from the assumption that convertible instruments are converted, that options or warrants are exercised, or that ordinary shares are issued upon the satisfaction of specified conditions.

2.7 Contingent share agreement

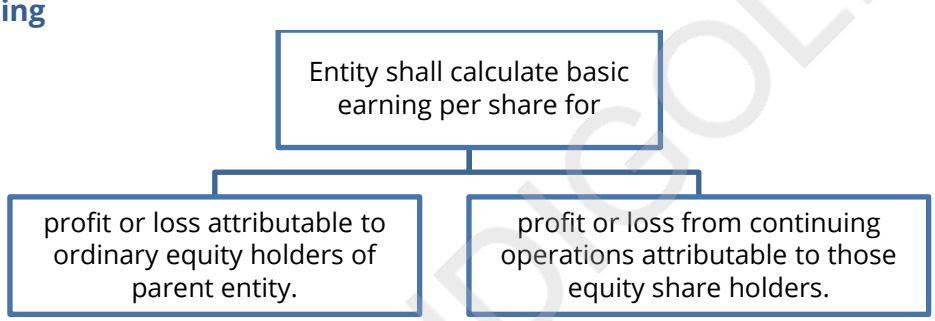
A contingent share agreement is an agreement to issue shares that is dependent on the satisfaction of specified conditions.

2.8 Contingently issuable ordinary shares

Contingently issuable ordinary shares are ordinary shares issuable for little or no cash or other consideration upon the satisfaction of specified conditions in a contingent share agreement.

3. Measurement of Basic Earnings Per Share

3.1 Meaning



3.2 Formula

Computation of Basic earnings per share =

$$\frac{\text{Profit/Loss attributable to Equity share holders}}{\text{Weighted average number of Equity shares outstanding during the period}}$$

3.3 Calculation of Profit attributable to Equity Share Holders

Earnings Before Interest & Taxes	**xxx**
Less: Finance cost (including dividend on Preference shares classified as Liability) [You will understand this after Ind AS 109]	xxx
Earnings before Taxes	**xxx**
Less: Taxes	xxx
Profit after tax	**xxx**
Less: Dividend on Cumulative Preference shares whether or not declared	xxx
Less: Dividend on Non-cumulative Preference shares only if declared	xxx
Less: Deemed dividend on increasing rate preference shares	xxx
Less: Redemption/Repurchase of Preference shares at premium	xxx
Less: Early conversion of Preference shares at premium	xxx
Profit attributable to Equity share holders	**xxx**

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3.3.1 Treatment of certain items in computation of profit attributable to equity share holders

1. Increasing rate Preference shares

Meaning	Treatment
Preference shares that provide for: - Low initial dividend to compensate an entity for selling the preference shares at a discount, or - An above-market dividend in later periods to compensate investors for purchasing Preference shares at a premium.	An original issue discount or premium on increasing rate preference shares is: - Amortised to retained earnings using the effective interest method, and - Treated as a preference dividend for the purposes of calculating earnings per share.

2. Redemption of Preference shares at premium

Amount	Treatment
The excess of the fair value of the consideration paid to the preference shareholders over the carrying amount of the preference shares represents: - A return to the holders of the preference shares, and - A charge to retained earnings for the entity.	This amount is deducted in calculating profit or loss attributable to ordinary equity holders of the parent entity.

3. Early conversion Of Preference shares at premium

Amount	Treatment
The excess of the fair value of the ordinary shares or other consideration paid over the fair value of the ordinary shares issuable under the original conversion terms is a return to the preference shareholders.	This amount is deducted in calculating profit or loss attributable to ordinary equity holders of the parent entity.

4. Excess payment to Preference share holders

Excess of the carrying amount of preference shares over the fair value of the consideration paid to settle them is added in calculating profit or loss attributable to ordinary equity holders of the parent entity.

5. After tax amounts of Preference dividends

Includes	Excludes
- After-tax preference dividend declared in respect of the period, on Non-cumulative preference shares. - After-tax preference dividend required for current period on Cumulative preference shares, whether or not dividends have been	Dividends on Cumulative preference shares paid or declared during the current period, in respect of previous periods.

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provided for.	

3.4 Shares

3.4.1 Calculation of Weighted Average Number of Shares

Ordinary shares outstanding at the beginning of the period	xxx
Add: Ordinary shares issued during year (weighted)	xxx
Add: Bonus issue (no time weightage factor)	xxx
Add: Right issue (time weighted)	xxx
Less: Ordinary shares bought back during the year (weighted)	xxx
Weighted average number of shares	**xxx**

Bonus shares are assumed to have been issued at the beginning of earliest period reported or date of issue of original shares during the year.

3.4.2 Deciding the date for issue of shares

Shares are usually included in the weighted average number of shares from the date consideration is receivable (which is generally the date of their issue),

When ordinary shares are issued	Timing effective from the date
In exchange for cash	When cash is receivable
On voluntary reinvestment of dividends on ordinary or preference shares	When dividends are reinvested
As a result of conversion of a debt instrument to ordinary shares	When Interest ceases to accrue
In place of interest or principal on other financial instruments	When Interest ceases to accrue
In exchange for the settlement of a liability	On settlement date
As consideration for the acquisition of an asset other than cash	When the acquired asset is recognised
For rendering of services to the entity	When the services are rendered
As a part of the consideration transferred in a business combination	From the date of the acquisition
Upon the conversion of a mandatorily convertible instrument	From the date of entering into the contract

3.4.3 Contingently issuable shares

- Treated as outstanding and included in the calculation of basic earnings per share only from the date when all necessary conditions are satisfied.
- Shares that are issuable solely after the passage of time are not contingently issuable shares, because the passage of time is a certainty.

3.4.4 Contingently returnable shares

Outstanding ordinary shares that are contingently returnable are not treated as outstanding and are excluded from the calculation of basic earnings per share until the date the shares are no longer subject to recall.

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3.4.5 Change in the number of shares without change in value of capital

Example	Treatment
- A capitalisation or bonus issue - A share split	- The number of ordinary shares outstanding is increased without an increase in resources. - The number of shares outstanding shall be adjusted as if the event occurred at the beginning of the earliest period presented.
- A reverse share split	- The number of ordinary shares outstanding is reduced without a reduction in resources. - The number of shares outstanding shall be adjusted as if the event occurred at the beginning of the earliest period presented.

3.4.6 Right issues

- Entities might raise additional capital by issuing shares to existing shareholders, on a pro rata basis to their existing holdings, in the form of a rights issue.
- The right shares can either be offered at the current market price or at a price that is below the current market price.
- A right issue usually includes a bonus element.

EPS Computation in case of Right shares:

Theoretical ex-rights (TERP) fair value per share=

$$\frac{\boldsymbol{FV\ of\ all\ outstanding\ shares\ before\ rights + Total\ amount\ received\ from\ rights}}{\boldsymbol{No\ of\ original\ shares + rights\ shares}}$$

Adjustment factor=

Fair value before rights issue
Theoretical ex-rights price

*Adjusting factor should be applied to adjust the shares outstanding before the right issue, both for the current and previous year.

Example
Rights issue 1:5 (1 shares for 5 issued)
Rights issue price – Rs. 15
Cum Rights Price – Rs. 20 [FV before rights]

TERP = (20x5)+(1x15)/(5+1)

$$\frac{(20x5) + (1x15)}{5 + 1} = 19.16$$

4. Measurement of Diluted Earnings Per Share

4.1 Meaning

Potential equity shares should be treated as dilutive when, and only when their conversion to equity shares would decrease net profit per share from continuing ordinary operations.

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4.2 Formula

Computation of Diluted earnings per share =

$$\frac{\text{Profit/Loss attributable to Equity share holders when dilutive potential shares are converted into ordinary shares}}{\text{Weighted average number of Equity shares+ Weighted average number of dilutive potential ordinary shares}}$$

4.3 Calculation

- Dilutive potential ordinary shares shall be deemed to have been converted into ordinary shares **at the beginning of the period or the date of issue of the potential ordinary shares, whichever is later.**
- Potential ordinary shares that are canceled or lapsed during the period are included in the calculation of diluted earnings per share for the portion of the period during which they are outstanding.
- Potential ordinary shares that are converted into ordinary shares during the period are included in the calculation of diluted earnings per share from the beginning of the period till the date of conversion.

  From the date of conversion, the resulting ordinary shares are included in both basic and diluted earnings per share.

- The conversion of the potential ordinary shares into ordinary shares should assume the most advantageous conversion rate or exercise price from the standpoint of the holder.
- Only potential ordinary shares that are dilutive are considered in the calculation of diluted earnings per share.

4.4 Steps for computing Diluted EPS

Step1 Compute Incremental EPS for each potential Ordinary share

- Incremental EPS=Effect of potential share on earnings to equity holders
- Effect of potential share on weighted average number of shares

Step2 Ranking

- Rank the various types of potential ordinary shares based on step1 above.First rank is given for least earning per incremental ordinary share and so on, in ascending order.

Step3 Compute Diluted EPS

- compute Basic EPS
- Add net profit and additional shares for each type of potential ordinary share, in ascending order.
- calculate Diluted EPS at each stage
- Select least Diluted EPS, which to be reported.If Diluted EPS increases at any point it will be considered Anti-Dilutive.

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4.5 Shares of subsidiary, joint venture or associate

If the potential ordinary shares of the subsidiary, joint venture or associate have a dilutive effect on the basic earnings per share of the reporting entity, they are included in the calculation of diluted earnings per share.

4.6 Options, warrants and their equivalents

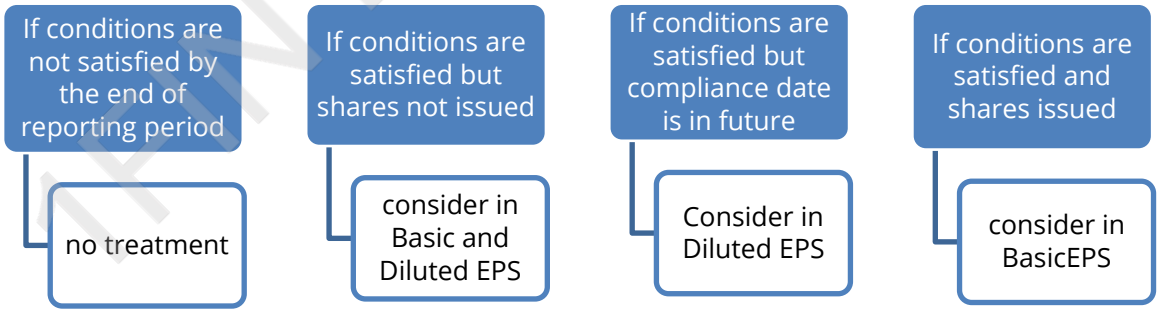
- The difference between the number of ordinary shares issued and the number of ordinary shares that would have been issued at the average market price of ordinary shares during the period shall be treated as an issue of ordinary shares for no consideration and should be included in the calculation of diluted earning per share.
- when the average market price of ordinary shares during the period exceeds the exercise price, Options and warrants have a dilutive effect, and Previously reported earnings per share are not retroactively adjusted to reflect changes in prices of ordinary shares.

4.7 Employee Stock Options

- Employee share options with fixed or determinable terms and non-vested ordinary shares are treated as options in the calculation of diluted earnings per share, even though they may be contingent on vesting. They are treated as outstanding on the grant date.
- Performance-based employee share options are treated as contingently issuable shares because their issue is contingent upon satisfying specified conditions in addition to the passage of time.
- Dilutive effect on ESOP:
  In case of vested ESOPs, potential equity shares will be calculated as:
  Total ESOP - (exercise price x Number of options/average fair value)

4.8 Contingently issuable shares

Contingency involves some amount of uncertainty, it depends on happening or not happening of a particular event. If all the conditions which were uncertain become certain, one can include contingently issued shares in the calculation of Basic and diluted EPS.



4.9 Entity with discontinued operations

An entity that reports a discontinued operation should use income from continuing operations, adjusted for preferred dividends and similar adjustments, if any, as the "control number" in determining whether potential common shares are dilutive. That is, the same number of potential common shares used in computing the diluted per-share amount of income from continuing

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operations should be used in computing all other reported diluted per-share amounts even if the effect will be anti-dilutive compared to their respective basic per-share amounts.

4.10 Convertible instruments

Convertible preference shares	Convertible debt
- The dilutive effect of convertible preference shares shall be reflected in diluted EPS. - Convertible preference shares are anti-dilutive when the amount of the dividend on such shares obtainable on conversion exceeds basic earnings per share (Incremental EPS>Basic EPS)	- The dilutive effect of convertible debt shall be reflected in diluted EPS. - Convertible debt is anti-dilutive whenever its interest (net of tax) per ordinary share obtainable on conversion exceeds basic earnings per share.

4.11 Contracts that may be settled in ordinary shares or cash

- When an entity has issued a contract that may be settled in ordinary shares or cash at the entity's option, the entity shall presume that the contract will be settled in ordinary shares, and the resulting potential ordinary shares shall be included in diluted earnings per share if the effect is dilutive.
- If contracts may be settled in ordinary shares or cash at the holder's option, the more dilutive cash settlement and share settlement shall be used in calculating diluted earnings per share.

4.12 Purchased options

Contracts such as purchased put options and purchased call options are not included in the calculation of diluted earnings per share because including them would be antidilutive.

4.13 Written put options

- Contracts that require the entity to repurchase its own shares, such as written put options and forward purchase contracts, are reflected in the calculation of diluted earnings per share if the effect is dilutive.
- If the exercise price is above the average market price, then-
  - It shall be assumed that at the beginning of the period sufficient ordinary shares will be issued and the proceeds from the issue are used to satisfy the contract.
  - Incremental ordinary shares shall be included in the calculation of diluted earnings per share.

5. Retrospective Adjustments

- If the number of ordinary or potential ordinary shares outstanding increases due to capitalisation, bonus issue or share split, or decreases as a result of a reverse share split, the basic and diluted earnings per share for all periods presented shall be adjusted retrospectively.
- If the changes occur after the reporting period but before the financial statements are approved for the issue, the per-share calculation for those and any prior period shall be based on the new number of shares.

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- Basic and diluted earnings per share of all periods presented shall be adjusted for the effects of errors and adjustments resulting from changes in accounting policies accounted for retrospectively.

6. Participating equity instruments and two-class ordinary shares

1. The equity of some entities includes:
   - Instruments that participate in dividend with ordinary shares according to a predetermined with, at times, an upper limit on the extent of participation.
   - a class of ordinary shares with a different dividend rate from that of another class of ordinary shares but without prior or senior rights.

2. Profit or loss for the period is allocated to the different classes of shares and participating equity instruments in accordance with their dividend rights or other rights:
   - profit or loss attributable to ordinary equity holders of the parent entity is adjusted by the amount of dividend for each class of shares.
   - the remaining profit or loss is allocated to ordinary shares and participating equity instruments to the extent that each instrument shares in earnings as if all of the profit or loss for the period had been distributed.
   - The total amount of profit or loss allocated to each class of equity instrument is divided by the number of outstanding instruments to which the earnings are allocated to determine the earnings per share for the instrument.

7. Presentation

- An entity shall present in the statement of profit and loss basic and diluted earnings per share.
- An entity shall present basic and diluted earnings per share with equal prominence for all periods.
- An entity shall present basic and diluted earnings per share even if it is negative.
- If the company does not have any potential ordinary shares, the company need not mention basic earnings per share and diluted earnings per share separately on two different lines. It can just mention on one line.
- One should not misunderstand that earnings per share have to be presented only when the company has profits.

8. Disclosure

- The amounts used as the numerators in calculating basic and diluted earnings per share and a reconciliation to the profit or loss.
- The weighted average number of ordinary shares used as the denominator in calculating basic and diluted earnings per share and a reconciliation of the denominators to each other.
- Instruments (including contingently issuable shares) that could potentially dilute basic earnings per share in the future, but not included in the calculation of diluted earnings per share.
- Description of ordinary share transactions or potential ordinary share transactions.

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1. Illustration

ABC Ltd. issues 9% preference shares of fair value of Rs. 10 each on 1.4.20X1. Total value of the issue is Rs. 10,00,000. The shares are issued for a period of 5 years and would be redeemed at the end of 5th year. The shares are to be redeemed at Rs. 11 each. At the end of the year 3, i.e. on 31.3.20X4, company finds that it has earned good returns than expected over last three years and can make the redemption of preference shares early. To compensate the shareholders for two years of dividend which they need to forego, company decided to redeem the shares at Rs. 12 each instead of original agreement of Rs. 11. Comment on the impact of early conversion of preference shares at a premium on earnings for the year 20X3- 20X4 attributable to ordinary equity holders of ABC Ltd. for basic EPS. Ignore the EIR impact in the solution and answer on the basis of Ind AS 33 only.

2. Illustration

An entity has following preference shares in issue at the end of 20X4:

- 5% redeemable, non-cumulative preference shares: These shares are classified as liabilities. During the year, a dividend was paid on the 5% preference shares – Rs. 100,000.
- Increasing-rate, cumulative, non-redeemable preference shares issued at a discount in 20X0, with a cumulative dividend rate from 20X5 of 10%: The shares were issued at a discount to compensate the holders, because dividend payments will not commence until 20X5. The accrual for the discount in the current year, calculated using the effective interest method amounted to, say, Rs. 18,000. These shares are classified as equity – Rs. 200,000.
- 8% non-redeemable, non-cumulative preference shares: At the beginning of the year, the entity had Rs. 100,000 8% preference shares outstanding but, at 30 June 20X4, it repurchased Rs. 50,000 of these at a discount of Rs. 1,000 – Rs. 50,000.
- 7% cumulative, convertible preference shares (converted in the year): These shares were classified as equity, until their conversion into ordinary shares at the beginning of the year. No dividend was accrued in respect of the year, although the previous year's dividend was paid immediately prior to conversion. To induce conversion, the terms of conversion of the 7% convertible preference shares were also amended, and the revised terms entitled the preference shareholders to an additional 100 ordinary shares on conversion with a fair value of Rs. 300 – Nil.

The profit after tax for the year 20X4 is Rs. 150,000.
Determine the adjustments for the purpose of calculating EPS.

3. Illustration

On 31 March, 20X2, the issued share capital of a company consisted of Rs. 100,000,000 in ordinary shares of Rs. 25 each and Rs. 500,000 in 10% cumulative non-redeemable preference shares (classified as equity) of Re 1 each. On 1 October, 20X2, the company issued 1,000,000 ordinary shares fully paid by way of capitalisation of reserves in the proportion 1:4 for the year ended 31 March, 20X3.
Profit for 20X1-20X2 and 20X2-20X3 is Rs. 450,000 and Rs. 550,000 respectively.
Calculate the basic EPS for 20X1-20X2 and 20X2-20X3..

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4. Illustration

1st January	1,000,000 shares in issue
28th February	Issued 200,000 shares at fair value
31st August	Bonus issue 1 shares for 3 shares held
30th November	Issued 250,000 shares at fair value.

Calculate the number of shares which would be used in basic EPS calculation if the reporting date is 31st December.

5. Illustration

At 31 December 20X1, the issued share capital of a company consisted of 1.8 million ordinary shares of Rs. 10 each, fully paid. The profits for the year ended 31 December 20X1 and 20X2 amounted to Rs. 630,000 and Rs. 875,000 respectively. On 31 March 20X2, the company made a rights issue on a 1 for 4 basis at Rs. 30. The market price of the shares immediately before the rights issue was Rs. 60.

Calculate EPS..

6. Illustration

ABC Ltd

1 January 20X1	Shares in issue 1,000,000

31 March 20X1
(a) Rights issue 1 for 5 at Rs. 90
(b) Fair value of shares Rs. 100 (cum-rights price)

Calculate the number of shares for use in the EPS calculation for the calendar year..

7. Illustration

Entity A has in issue 25,000 4% debentures with a nominal value of Re 1. The debentures are convertible to ordinary shares at a rate of 1:1 at any time until 20X9. The entity's management receives a bonus based on 1% of profit before tax.
Entity A's results for 20X2 showed a profit before tax of Rs. 80,000 and a profit after tax of Rs. 64,000 (for simplicity, a tax rate of 20% is assumed in this question).

Calculate Earnings for the purpose of diluted EPS..

8. Illustration

ABC Ltd. has 1,000,000 Rs. 1 ordinary shares and 1,000 Rs. 100 10% convertible bonds (issued at par), each convertible into 20 ordinary shares on demand, all of which have been in issue for the whole of the reporting period.
ABC Ltd.'s share price is Rs. 4.50 per share and earnings for the period are Rs. 500,000. The tax rate applicable to the entity is 21%.
Calculate basic EPS, earnings per incremental share for the convertible bonds and diluted EPS.

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9. Illustration

At 30 June 20X1, the issued share capital of an entity consisted of 1,500,000 ordinary shares of Rs. 1 each. On 1 October 20X1, the entity issued Rs. 1,250,000 of 8% convertible loan stock for cash at par. Each Rs. 100 nominal value of the loan stock may be converted, at any time during the years ended 20X6 to 20X9, into the number of ordinary shares set out below:
30 June 20X6: 135 ordinary shares;
30 June 20X7: 130 ordinary shares;
30 June 20X8: 125 ordinary shares; and
30 June 20X9: 120 ordinary shares.
If the loan stocks are not converted by 20X9, they would be redeemed at par.
It is assumed that the written equity conversion option is accounted for as a derivative liability and marked to market through profit or loss. The change in the options' fair value reported in 20X2 and 20X3 amounted to losses of Rs. 2,500 and Rs. 2,650 respectively. It is assumed that there are no tax consequences arising from these losses.
The profit before interest, fair value movements and taxation for the year ended 30 June 20X2 and 20X3 amounted to Rs. 825,000 and Rs. 895,000 respectively and relate wholly to continuing operations. The rate of tax for both periods is 33%.
Calculate Basic and Diluted EPS.

10. Illustration

At 31 December 20X7 and 20X8, the issued share capital of an entity consisted of 4,000,000 ordinary shares of Rs. 25 each. The entity has granted options that give holders the right to subscribe for ordinary shares between 20Y6 and 20Y9 at Rs. 70 per share. Options outstanding at 31 December 20X7 and 20X8 were 630,000. There were no grants, exercises or lapses of options during the year. The profit after tax, attributable to ordinary equity holders for the years ended 31 December 20X7 and 20X8, amounted to Rs. 500,000 and Rs. 600,000 respectively (wholly relating to continuing operations).

Average market price of share:
Year ended 31 December 20X7 = Rs. 120
Year ended 31 December 20X8 = Rs. 160

Calculate basic and diluted EPS.

11. Illustration

Ordinary shares outstanding during 20X1 - 1,000,000 (there were no options, warrants or convertible instruments outstanding during the period)

An agreement related to a recent business combination provides for the issue of additional ordinary shares based on the following conditions:
- 5,000 additional ordinary shares for each new retail site opened during 20X1
- 1,000 additional ordinary shares for each Rs. 1,000 of consolidated profit more than Rs. 2,000,000 for the year ended 31 December 20X1

Retail sites opened during the year:
- one on 1 May 20X1
- one on 1 September 20X1

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Consolidated year-to-date profit attributable to ordinary equity holders of the parent entity:
- Rs. 1,100,000 as of 31 March 20X1
- Rs. 2,300,000 as of 30 June 20X1
- Rs. 1,900,000 as of 30 September 20X1 (including Rs. 450,000 loss from a discontinued operation)
- Rs. 2,900,000 as of 31 December 20X1

Calculate basic and diluted EPS.

12. Illustration

Assume the following facts for Company XY:
- Income from continuing operations: 30,00,000
- Loss from discontinued operations: (36,00,000)
- Net loss: (6,00,000)
- Weighted average Number of shares outstanding – 10,00,000
- Incremental common shares outstanding relating to stock options – 2,00,000

Calculate Basic and Diluted EPS

Assume, if in above case, Loss from continued operations is Rs. 10,00,000 and income from discontinued operations is Rs. 36,00,000 calculate the diluted EPS..

13. Illustration

An entity issues 2,000 convertible bonds at the beginning of Year1. The bonds have a three- year term and are issued at par with a face value of Rs. 1,000 per bond, giving total proceeds Rs. 2,000,000. Interest is payable annually in arrears at a nominal annual interest rate of 6 per cent. Each bond is convertible at any time up to maturity into 250 ordinary shares. The entity has an option to settle the principal amount of the convertible bonds in ordinary shares or in cash.
When the bonds are issued, the prevailing market interest rate for similar debt without a conversion option is 9 per cent. At the issue date, the market price of one ordinary share is Rs. 3. Income tax is ignored.

Calculate basic and diluted EPS when Profit attributable to ordinary equity holders of the parent entity Year 1 Rs. 1,000,000

Ordinary shares outstanding	1,200,000
Convertible bonds outstanding	2,000

14. Illustration

1 January Shares in issue 1,000,000
5% Convertible bonds Rs. 100,000
(Terms of conversion 120 ordinary shares for Rs. 100)

On 31 March Holders of Rs. 25,000 bonds converted to ordinary shares.

Profit for the year ended 31 December Rs. 200,000
Tax rate 30%.

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Calculate basic and diluted EPS.
Ignore the need to split the convertible bonds into liability and equity elements.

15. Illustration

An entity has two classes of shares in issue:

- 5,000 non-convertible preference shares
- 10,000 ordinary shares

The preference shares are entitled to a fixed dividend of Rs. 5 per share before any dividends are paid on the ordinary shares.

Ordinary dividends are then paid in which the preference shareholders do not participate. Each preference share then participates in any additional ordinary dividend above Rs. 2 at a rate of 50% of any additional dividend payable on an ordinary share.
The entity's profit for the year is Rs. 100,000, and dividends of Rs. 2 per share are declared on the ordinary shares.
Compute the allocation of earnings for the purpose of calculation of Basic EPS when an entity has ordinary shares & participating equity instruments that are not convertible into ordinary shares.

16. Illustration

Profit attributable to equity holders of the parent entity Rs. 100,000
Ordinary shares outstanding 10,000
Non-convertible preference shares 6,000

Non-cumulative annual dividend on preference shares (before any dividend is paid on ordinary shares) Rs. 5.50 per share

After ordinary shares have been paid a dividend of Rs. 2.10 per share, the preference shares participate in any additional dividends on a 20:80 ratio with ordinary shares.

17. Illustration

	20X0	20X1	20X2
Profit attributable to ordinary equity holders of the parent entity	Rs. 1,100	Rs. 1,500	Rs. 1,800

Shares outstanding before rights issue	500 shares
Rights issue	One new share for each fiveoutstanding shares
Exercise price	Rs. 5.00
Date of rights issue	1 January 20X1
Last date to exercise rights	1 March 20X1
Market price of one ordinary share immediately before exercise on 1st March 20X1:	Rs. 11.00
Reporting date	31 December

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Compute the EPS.

18. Illustration

Parent:

Profit attributable to ordinary equity holders of the parent entity	Rs. 12,000 (excluding any earnings of, or dividends paid by, the subsidiary)
Ordinary shares outstanding	10,000
Instruments of subsidiary owned by the parent	800 ordinary shares 30 warrants exercisable to purchase ordinary shares of subsidiary 300 convertible preference shares

Subsidiary:

Profit	Rs. 5,400
Ordinary shares outstanding	1,000
Warrants	150, exercisable to purchase ordinary shares of the subsidiary
Exercise price	Rs. 10
Average market price of one ordinary share	Rs. 20
Convertible preference shares	400, each convertible into one ordinary share
Dividends on preference shares	Rs. 1 per share

No inter-company eliminations or adjustments were necessary except for dividends.

Ignore income taxes. Also, ignore classification of the components of convertible financial instruments as liabilities and equity or the classification of related interest and dividends as expenses and equity as required by Ind AS 32.

19. Illustration

CAB Limited is in the process of preparation of the consolidated financial statements of the group for the year ending 31st March, 20X3 and the extract of the same is as follows:

Particulars	Attributable to CAB Limited	Non-controlling interest	Total (Rs. in '000)
Profit for the year	39,000	3,000	42,000
Other Comprehensive Income	5,000	Nil	5,000
Total Comprehensive Income	44,000	3,000	47,000

The long-term finance of the company comprises of the following:

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(i) 20,00,00,000 equity shares at the beginning of the year and the company has issued 5,00,00,000 shares on 1st July, 20X2 at full market value

(ii) 8,00,00,000 irredeemable preference shares. These shares were in issue for the whole of the year ended 31st March, 20X3. The dividend on these preference shares is discretionary.

(iii) Rs. 18 crores of 6% convertible debentures issued on 1st April, 20X1 and repayable on 31st March, 20X5 at par. Interest is payable annually. As an alternative to repayment at par, the holder on maturity can elect to exchange their convertible debentures for 10 crores ordinary shares in the company. On 1st April, 20X1, the prevailing market interest rate for four-year convertible debentures which had no right of conversion was 8%. Using an annual discount rate of 8%, the present value of Rs. 1 payable in four years is 0.74 and the cumulative present value of Rs. 1 payable at the end of years one to four is 3.31.

In the year ended 31st March, 20X3, CAB Limited declared an ordinary dividend of 0.10 paise per share and a dividend of 0.05 paise per share on the irredeemable preference shares.

Compute the following:

- the finance cost of convertible debentures and its closing balance as on 31st March, 20X3 to be presented in the consolidated financial statements.
- the basic and diluted earnings per share for the year ended 31st March, 20X3.
- Assume that income tax is applicable to CAB Limited and its subsidiaries at 25%.

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IND AS 37
PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

1 Objective

The objective of Ind AS 37 is to ensure that

- appropriate ***recognition*** criteria and ***measurement*** bases are applied to
  - -provisions,
  - -contingent liabilities and
  - -contingent assets and
- ***sufficient information*** is disclosed in the notes to enable users to understand their
  - -nature,
  - -timing and
  - -amount.

2 Scope

Ind AS 37 should be applied by all entities in accounting for provisions, contingent liabilities and contingent assets, except:

1) for **executory contracts**, except where the contract is onerous; and
2) **financial instruments** that are within the scope of Ind AS 109, Financial Instruments;
3) those covered by another Standard such as:

Exclusion	Covered by
Revenue from contracts with customers	Ind AS 115 (Onerous contracts covered under Ind AS 37)
Income Taxes	Ind AS 12
Leases	Ind AS 116 (Onerous contracts covered under Ind AS 37)
Employee Benefits	Ind AS 19
Insurance Contracts	Ind AS 104
Contingent consideration in a business combination	Ind AS 103

3 Important Terms

3.1 Executory Contract

- Executory contracts are contracts under which
  - neither party has performed any of its obligations or
  - both parties have partially performed their obligations to an equal extent

Ind AS 37 is applied to executory contracts only if they are onerous.

3.2 Onerous Contract

- is a contract in which the unavoidable costs of meeting the obligation
- exceed the economic benefits expected to be received under the contract

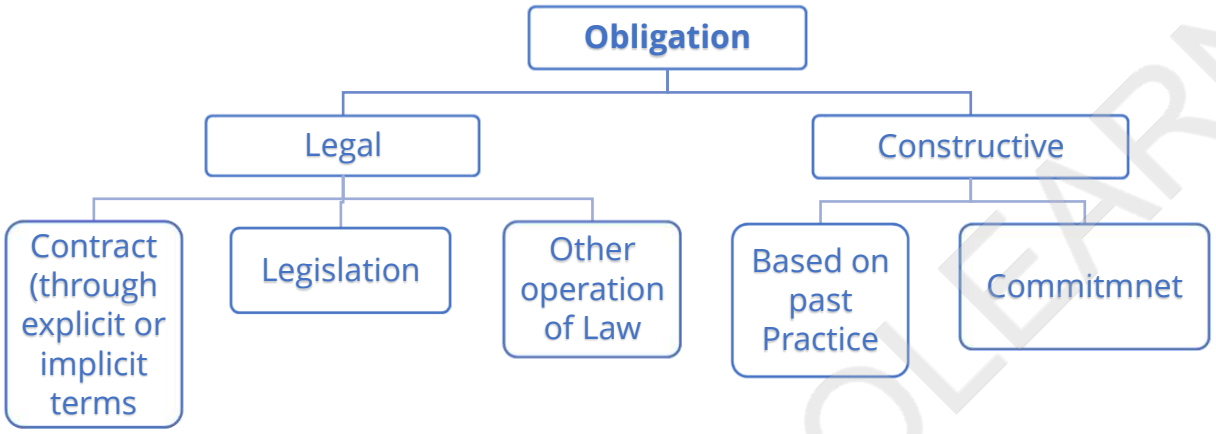
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3.3 Liability

- is a present obligation of the entity
- arising from past events,
- the settlement of which is expected to result
- in an outflow from the entity of resources embodying economic benefits.

3.4 Obligating Event

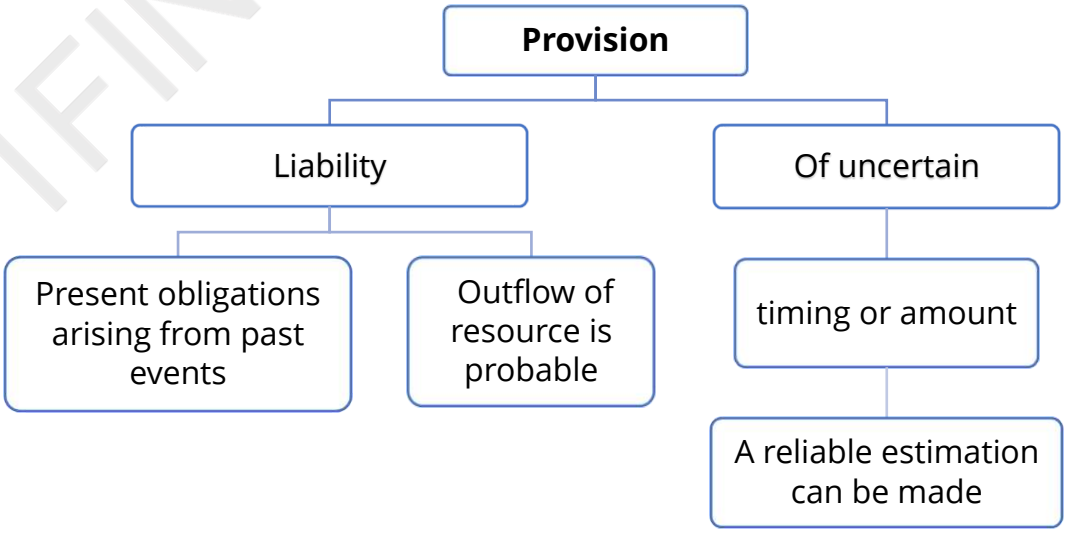
- is an event that creates a legal or constructive obligation
- that results in an entity having no realistic alternative to settling that obligation.



Example: X Ltd. is engaged in the manufacture of fertilisers. Effluents discharged in the manufacturing process have polluted the river near the manufacturing plant. The residents of the nearby locality launched a massive agitation against the pollution as a result X Ltd. agreed to their demands to reduce the water pollution by installing the necessary Effluent Treatment Plant.
However, during the year no steps are taken to install the plant. No legislation requiring the company to reduce its pollution is in existence.
In this case, though there is no law but by promising to take steps to reduce pollution, X Ltd. has created a valid expectation on the part of public that it will discharge its responsibilities. So, the obligation in this case is a **constructive obligation.**

4 Provisions

A *provision* is a liability of uncertain ***timing*** or ***amount.***

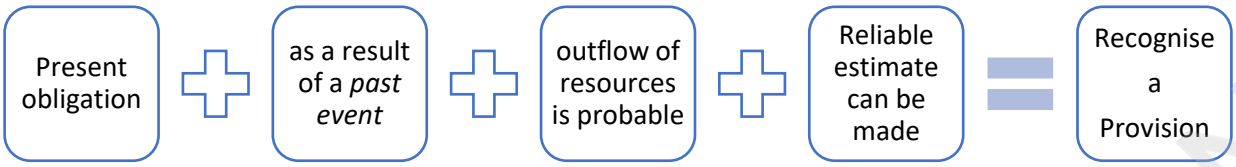


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4.1 Recognition of Provision

provision should be recognised when all the conditions are satisfied

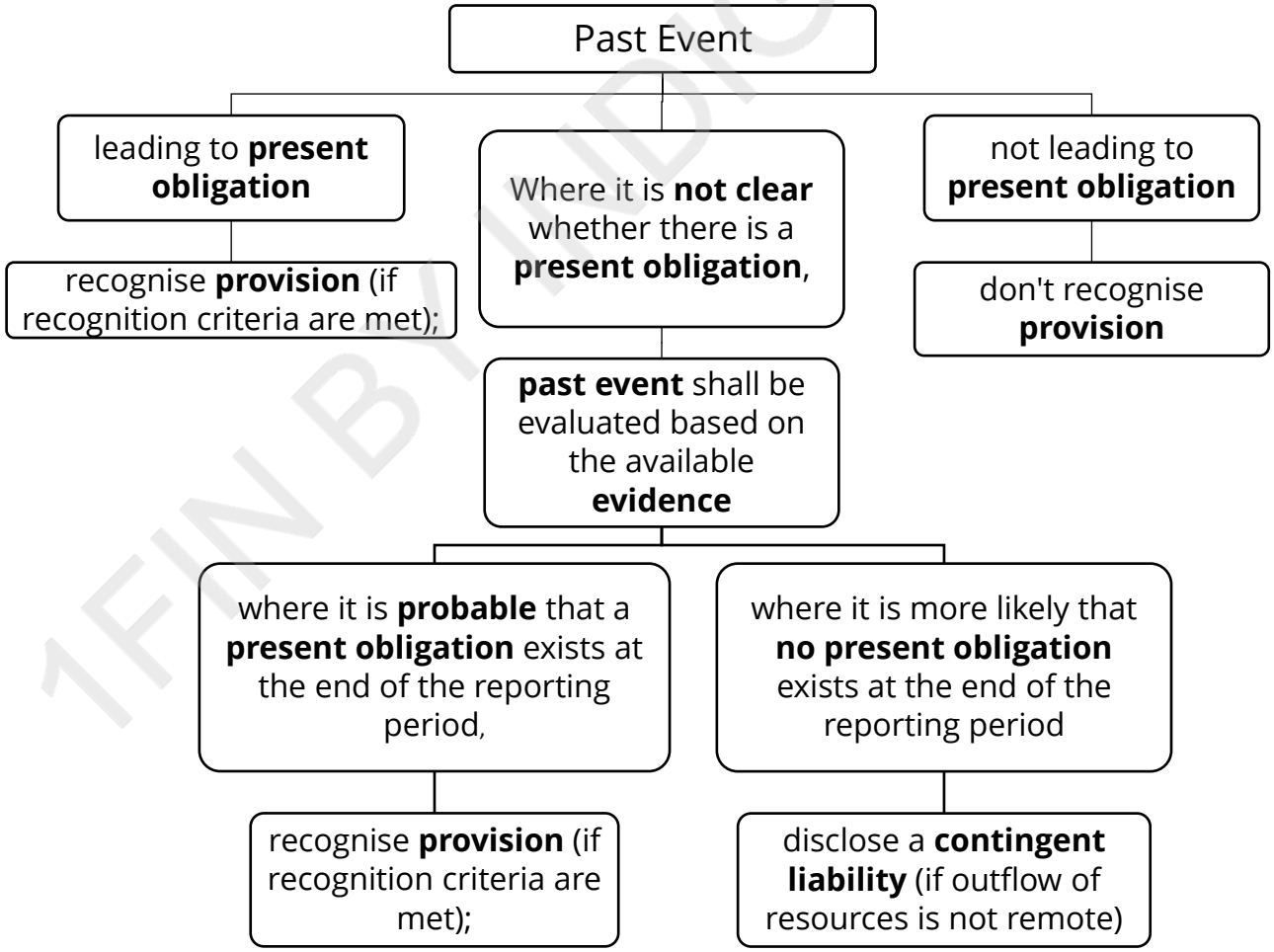
a) an entity has a *present obligation* (legal or constructive) as a result of a *past event;*
b) it is *probable that an outflow of resources embodying economic benefits* will be required to settle the obligation; and
c) a *reliable estimate* can be made of the amount of the obligation.



4.1.1 Past Event and Present Obligation

- A ***past event*** that leads to a ***present obligation*** is called an ***obligating event***.
- ***Obligating event***, is the event where the entity has no realistic alternative to settling the obligation created by the event. This is the case only:

a) where the settlement of the obligation can be enforced by law; or
b) in the case of a constructive obligation, where the event (which may be an action of the entity) creates valid expectations in other parties that the entity will discharge the obligation.



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➔ ***No provision is recognised for costs that need to be incurred by an entity to operate in the future.***

➔ ***Only those obligations arising from past events existing independently of an entity's future actions (i.e., the future conduct of its business) that should be recognised as provisions***

Example 1: Refurbishment costs

Case(i): No legislative requirement

A furnace has a lining that needs to be replaced every five years for technical reasons. At the end of the reporting period, the lining has been in use for three years. It is assumed that a reliable estimate can be made of any outflows expected.

Present obligation as a result of a past obligating event – No present obligation

Conclusion – No provision is recognised.

Note: The cost of replacing the lining is not recognised because, at the end of the reporting period, no obligation to replace the lining exists **(even if the company has plans to replace the linings)**

Case(ii): legislative requirement

An airline is required by law to overhaul its aircraft once every three years. It is assumed that a reliable estimate can be made of any outflows expected.

Present obligation as a result of a past obligating event – There is no present obligation.

Conclusion – No provision is recognised.

Note: The costs of overhauling aircraft are not recognised as a provision for the same reasons as the cost of replacing the lining is not recognised as a provision in Case(i) on refurbishment costs.

Even a legal requirement to overhaul does not make the costs of overhaul a liability, because no obligation exists to overhaul the aircraft - the entity could avoid the future expenditure by its future actions, for example by selling the aircraft.

➔ ***The entity can avoid the future expenditure by its future actions. In such a case, it has no present obligation for that future expenditure and no provision is recognised.***

Example 2: Legal requirement to fit smoke filters

Under new legislation, an entity is required to fit smoke filters to its factories by September 30, 20X1. The entity has not fitted the smoke filters. It is assumed that a reliable estimate can be made of any outflows expected.

(a) At March 31, 20X1, the end of the reporting period

Present obligation as a result of a past obligating event – There is no obligation because there is no obligating event either for the costs of fitting smoke filters or for fines under the legislation.

Conclusion – No provision is recognised for the cost of fitting the smoke filters.

(b) At March 31, 20X2, the end of the reporting period

Present obligation as a result of a past obligating event – There is still no obligation for the costs of fitting smoke filters because no obligating event has occurred (the fitting of the filters). However, an obligation might arise to pay fines or penalties under the legislation because the obligating event has occurred (the non-compliant operation of the factory).

An outflow of resources embodying economic benefits in settlement – Assessment of probability of incurring fines and penalties by non-compliant operation depends on the details of the legislation and the stringency of the enforcement regime.

Conclusion – No provision is recognised for the costs of fitting smoke filters. However, a provision is recognised for the best estimate of any fines and penalties that are more likely than not to be imposed.

4.1.2 Probable Outflow of Resources Embodying Economic Benefits

- For a liability to qualify for recognition
  - there must be not only a ***present obligation***
  - but also, the probability of an ***outflow of resources*** embodying economic benefits to settle that obligation.
- Where it is not probable that a present obligation exists,
  - an entity discloses a ***contingent liability***,
  - unless the possibility of an outflow of resources embodying economic benefits is ***remote***.

For the purpose of Ind AS 37, an outflow of resources or other event is regarded as probable, if the event is more likely than not to occur, i.e., the probability that the event will occur is greater than the probability that it will not.

Example 3: Refurbishment costs – legislative requirementAn entity in the oil industry causes contamination but cleans up only when required to do so under the laws of the particular country in which it operates.

One country in which it operates has had no legislation requiring cleaning up, and the entity has been contaminating land in that country for several years.

At March 31, 20X1, it is virtually certain that a draft law requiring a clean-up of land already contaminated will be enacted shortly after the year-end. It is assumed that a reliable estimate can be made of any outflows expected.

Present obligation as a result of a past obligating event – The obligating event is the contamination of the land because of the virtual certainty of legislation requiring cleaning up.

An outflow of resources embodying economic benefits in settlement – Probable.

Conclusion – A provision is recognised for the best estimate of the costs of the clean-up.

Example 4: Contaminated land and constructive obligation

An entity in the oil industry (having 31 March year-end) causes contamination and operates in a country where there is no environmental legislation.

However, the entity has a widely published environmental policy in which it undertakes to clean up all contamination that it causes. The entity has a record of honouring this published policy. It is assumed that a reliable estimate can be made of any outflows expected.

Present obligation as a result of a past obligating event- The obligating event is the contamination of the land, which gives rise to a constructive obligation because the conduct of the entity has

created a valid expectation on the part of those affected by it that the entity will clean up contamination.
An outflow of resources embodying economic benefits in settlement- Probable.
Conclusion- A provision is recognised for the best estimate of the costs of clean-up.

Example 5: Offshore oilfield
An entity operates an offshore oilfield where its licensing agreement requires it to remove the oil rig at the end of production and restore the seabed. 90% of the eventual costs relate to the removal of the oil rig and restoration of damage caused by building it, and 10% arise through the extraction of oil.
At the end of the reporting period, the rig has been constructed but no oil has been extracted. It is assumed that a reliable estimate can be made of any outflows expected.
Present obligation as a result of a past obligating event – The construction of the oil rig creates a legal obligation under the terms of the license to remove the rig and restore the seabed and is thus an obligating event.
At the end of the reporting period, however, there is no obligation to rectify the damage that will be caused by extraction of the oil.
An outflow of resources embodying economic benefits in settlement – Probable.
Conclusion – A provision is recognised for the best estimate of 90% of the eventual costs that relate to the removal of the oil rig and restoration of damage caused by building it. These costs are included as part of the cost of the oil rig.
The 10% of costs that arise through the extraction of oil are recognised as a liability when the oil is extracted.

4.2 Changes in Provisions

- Provisions should be reviewed at the end of each reporting period and adjusted to reflect the current best estimate
- If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, provision should be reversed.
- Where discounting is used, the carrying amount of a provision increases in each year. This increase is recognised as borrowing cost / finance cost.

4.3 Use of Provisions

A provision should be used only for expenditures for which the provision was originally recognised. Repurposing of the provisions is not allowed.

4.4 Provisions & Other Liabilities

Since there is uncertainty about the timing or amount of the future expenditure required in settlement of the provisions, they are different from liabilities. By contrast:

a) trade payables are liabilities to pay for goods or services that have been received or supplied.
b) accruals are liabilities to pay for goods or services that have been received or supplied but have not been paid.

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4.4.1 Examples on provisions and other liabilities:

Nature of obligation	Recognition as provision (Yes/No)	Reasons
Amount payable for utilities like electricity, gas, etc.	No	It represents an accrual of liability to pay for services that have been received and the amount and timing of payment can be determined with a reasonable certainty.
Goods or services received, but not invoiced	No	It represents trade payables even if invoice has not been received and the amount and timing of payment would be driven by the terms agreed with the supplier.
Financial guarantee given by the parent to lenders for loan taken by its subsidiary	No	Financial guarantees are within the scope of Ind AS 109 *Financial Instruments*
Warranty obligations	Yes	It is additional cost that the seller may have to incur to rectify product defects. This is in the nature of provision as there is an uncertainty associated with the amount and timing of the liability.

5 Contingent Liabilities

- A Contingent Liability is
  - a *possible obligation* that arises from *past events* and
  - whose existence will be confirmed only by the *occurrence or non-occurrence* of one or more uncertain *future events* not wholly within the control of the entity.

    (or)
  - a *present obligation* that arises from *past events* but is not recognised because:
  - *Outflow of resources* embodying economic benefits to settle the obligation are *not probable*; or
  - Reliable estimation cannot be made.

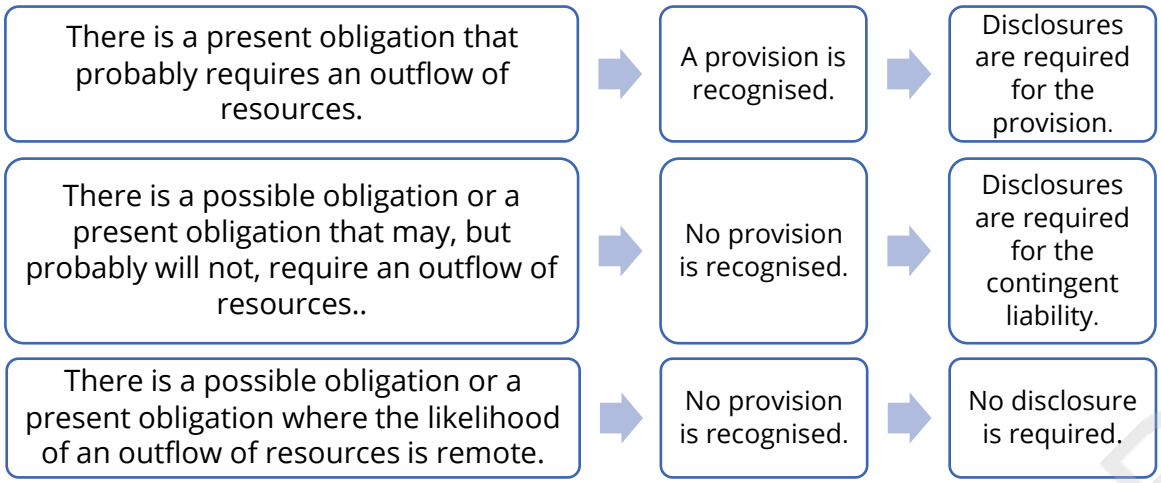
An entity should not recognise a contingent liability, it should be **disclosed**, unless possibility of an outflow of resources embodying economic benefits is not remote

Example:

A tax case pending before the court, the liability for payment arising or not in respect of which depends on the outcome of court decision is a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

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The principles describing provisions and contingent liabilities is as follows:



- If it becomes probable that an outflow of future economic benefits will be required for an item previously dealt with as a contingent liability, a provision should be recognised in the financial statements of the period in which the change in probability occurs.

6 Contingent Assets

- Contingent Asset is
  - a *possible asset* that arises from *past events* and
  - whose existence will be confirmed only by the *occurrence or non-occurrence* of one or more uncertain *future events* not wholly within the control of the entity
- An entity should not recognise a contingent asset
- A contingent asset should be disclosed, where an inflow of economic benefits is probable.
- Contingent assets are assessed continually to ensure that developments are appropriately reflected in the financial statements.
- If it has become virtually certain that an inflow of economic benefits will arise, the asset and the related income are recognised in the financial statements of the period in which the change occurs.

Likelihood of outcome	Probability	Contingent liability	Contingent asset
Virtually certain	> 95%	Recognise provision	Recognise asset
Probable	50% - 95%	Recognise Provision	Disclose
Possible but not probable	5% - 50%	Disclose the contingency	No disclosure
Remote	< 5%	Ignore	Ignore

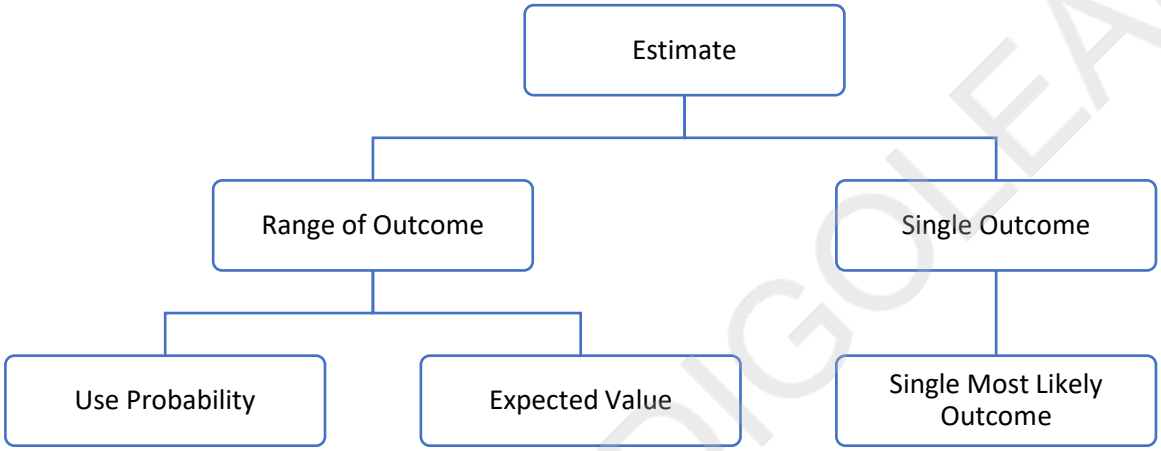
Example: X Ltd. filed a legal suit against a supplier of goods for compensation against damages on non–supply of contracted goods.
This meets the definition of a ***contingent asset*** since there is a possible asset (compensation against damages) that arises from past event (contract with the supplier) and whose existence will be confirmed by the occurrence or non-occurrence of uncertain future event not wholly within the control of the entity (i.e., the outcome of the legal suit).

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7 Measurement

7.1 Best Estimate

- The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.
- The estimates of outcome and financial effect are determined using
  - the judgement of the management of the entity,
  - experience of similar transactions,
  - reports from independent experts,
  - Subsequent events



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Example 1:
An entity faces a single legal claim, with a 40 per cent likelihood of success with no cost and a 60 percent likelihood of failure with a cost of ₹1 million.
Expected value is not valid in this case because the outcome will never be a cost of ₹600,000 (60 percent × ₹1 million); the outcome will either be nil or ₹1 million.
Ind AS 37 indicates that the provision may be estimated at the individual most likely outcome. In this case, it is more likely that a cost of ₹1 million will result and, therefore, a provision for ₹1 million should be recognised.
Example 2:
An entity is required to replace a major component of an asset under warranty. Each time replacement costs ₹ 1 million. From experience, there is a 30 per cent chance of a single failure, a 50 per cent chance of two failures, and a 20 per cent chance of three failures.
In the given case the most likely outcome is two failures, costing ₹ 2 million. The expected value is ₹ 1.9 million [(30 percent x ₹ 1 million) + (50 per cent x ₹ 2 million) + (20 per cent x ₹ 3 million)].

The expected value supports the provision 2 million.

7.2 Risk and Uncertainties

- Risks and uncertainties should be taken into account in reaching the best estimate of a provision.

- A risk adjustment should be made for the amount that the entity would pay in excess of the expected present value of outflows due to uncertainty attached with the actual outcome.
- Risk adjustment can be accounted for in number of ways such as:
  - Adding it to the expected present value of future outflows.
  - Adjusting the estimates of future outflows.
  - Adjusting the discount rate.

7.3 Present value

- The amount of a provision should be the **present value** of the expenditures expected to be required to settle the obligation.
- **The discount rate (or rates) should be a pre-tax rate (or rates)** that reflect(s) current market assessments of the time value of money and the risks specific to the liability.

7.4 Future Events

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 they will occur.

7.5 Expected Disposal of Asset

Gains on the expected disposal of assets should not be taken into account in measuring a provision, even if the expected disposal is closely linked to the event giving rise to the provision.

Example:
At the end of 20X1, an entity is demonstrably committed to the closure of some facilities, having drawn up a detailed plan and made appropriate announcements. The expected impact of the plan is as follows:

	20X2	**20X3**
Committed closure costs	₹ 10,00,000	
Gain from sale of property		₹ 2,00,000

The provision required at the end of 20X1 is ₹ 10,00,000 (ignoring discounting). The expected gain on the sale of the property is dealt with separately under the derecognition criteria in Ind AS 16.

8 Reimbursements

- Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognised when, and only when, it is **virtually certain** that reimbursement will be received if the entity settles the obligation.
- The reimbursement should be treated as a **separate asset**.
- The amount recognised for the reimbursement should **not exceed** the amount of the provision.
- In the statement of profit and loss, the expense relating to a provision may be presented net of the amount recognised for a reimbursement.

9 Application of Recognition & Measurement Rules

9.1 Future Operating Losses

- Provisions should not be recognised for future operating losses
- as future operating losses do not meet the definition of a liability

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9.2 Onerous Contracts

- contract in which unavoidable cost of meeting the obligation exceed the economic benefits expected to be received from such contract
- Provision to be created at Lower of:
  - Damages payable if exited from the contract or
  - Net loss that arises if the contract is executed

Example 1: Contract not onerous
An entity has a contract to purchase one million units of gas at 23p per unit, giving a contract price of ₹ 2,30,000. The current market price for a similar contract is 16p per unit, giving a price of ₹ 1,60,000.
The gas will be used to generate electricity, which will be sold at a profit. The economic benefits from the contract include the benefits to the entity of using the gas in its business and, because the electricity will be sold at a profit, the contract is not onerous.

Example 2: Impairment of assets
The contract's terms and market prices are the same as in example 1.
However, the electricity is sold at a loss, and the entity makes an overall operating loss. All of the gas purchased by the entity is used to generate electricity using dedicated assets. The electricity is sold to a wide range of customers. The entity first considers whether the assets used to generate electricity are impaired.
To the extent that there is still a loss after the assets have been written down, a provision for an onerous contract should be recorded.

Example 3: Sale to third party at below purchase price
The contract terms and market price are the same as in example 1.
However, in this example, the entity sells the gas under contract, which it no longer needs, to a third party for 18p per unit (5p below cost). The entity determines that it would have to pay ₹ 55,000 to exit the purchase contract.
The only economic benefit from the purchase contract costing ₹ 2,30,000 are the proceeds from the sales contract, which are ₹ 1,80,000.
Therefore, a provision should be made for the onerous element of ₹ 50,000, being the lower of the cost of fulfilling the contract and the penalty cost of cancellation (₹ 55,000).

9.3 Restructuring

- is a programme that is planned and controlled by management, and materially changes either
  a) the scope of a business undertaken by the entity; or
  b) the manner in which that business is conducted.

Examples,
  a) sale or termination of a line of business;
  b) closure of business locations in a country or region or the relocation of business activities from one country or region to another;
  c) changes in management structure, for example, eliminating a layer of management; and
  d) fundamental reorganisations that have a material effect on the nature and focus of the entity's operations
- A provision for restructuring costs should be recognised only when the general recognition criteria for provisions set out the standard are met.
- A constructive obligation to restructure arises only when an entity:

a) has a detailed formal plan for the restructuring identifying at least:
   i. business or part of a business concerned;
   ii. principal locations affected;
   iii. location, function, and approximate number of employees who will be compensated for terminating their services;
   iv. expenditures that will be undertaken; and
   v. when the plan will be implemented; and
b) has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.

- A restructuring provision should include only **include the direct expenditure arising from the restructuring,** which are:
  - necessarily entailed by the restructuring; and
  - **not associated with the on-going activities** of the entity.
- A restructuring provision does not include such cost as:
  - retraining or relocating continuing staff;
  - Marketing; or
  - Investment in new system and distribution networks.

Example 1: Closure of a division – no implementation before end of the reporting period
On March 12, 20X1 the board of an entity decided to close down a division. Before the end of the reporting period (March 31, 20X1) the decision was not communicated to any of those affected and no other steps were taken to implement the decision. it is assumed that a reliable estimate can be made of any outflows expected.

Present obligation as a result of a past obligating event – There has been no obligating event and so there is no obligation.
Conclusion – No provision is recognised.
Example 2: Closure of a division – communication/implementation before end of the reporting period
On March 12, 20X1, the board of an entity decided to close down a division making a particular product. On March 20, 20X1 a detailed plan for closing down the division was agreed by the board; letters were sent to customers warning them to seek an alternative source of supply and redundancy notices were sent to the staff of the division. It is assumed that a reliable estimate can be made of any outflows expected.
Present obligation as a result of a past obligating event **–** The obligating event is the communication of the decision to the customers and employees, which gives rise to a constructive obligation from that date, because it creates a valid expectation that the division will be closed.
An outflow of resources embodying economic benefits in settlement – Probable.
Conclusion – A provision is recognised at March 31, 20X1 for the best estimate of the costs of closing the division.

10 Disclosure Requirements

- For each class of provision, an entity should disclose:
  - the carrying amount at the beginning and end of the period;
  - additional provisions made in the period, including increases to existing provisions;
  - amounts used (i.e., incurred and charged against the provision) during the period;
  - unused amounts reversed during the period; and
  - the increase during the period in the discounted amount arising from the passage of time and the effect of any change in the discount rate.
- An entity should disclose the following for each class of provision:

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- a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits;
- an indication of the uncertainties about the amount or timing of those outflows.
- the amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement.

➢ Unless the possibility of any outflow in settlement is remote, an entity should disclose for each class of contingent liability at the end of the reporting period a brief description of the nature of the contingent liability and, where practicable:
- an estimate of its financial effect, measured in the standard;
- an indication of the uncertainties relating to the amount or timing of any outflow; and
- the possibility of any reimbursement.

➢ When an entity is creating a class of provisions, the entity should aggregate similar items

➢ Where an inflow of economic benefits is probable, an entity should disclose a brief description of the **nature of the contingent assets** at the end of the reporting period, and, where practicable, **an estimate of their financial effect**, measured using the principles set out for provisions in the standard.

11 Levies- Appendix C of Ind AS 37

11.1 What is Levy?

➢ A charge imposed by governments on entities in accordance with laws and/or regulations. It leads to outflow of resources embodying economic benefits

It excludes,
- outflows of resources that are within the scope of other Ind AS
- fines or other penalties that are imposed for breaches of the legislation
- payment made to the government for acquiring assets or for rendering services as per the contractual agreement
- liabilities that arise from emissions trading schemes.

Other relevant examples:

Example 1: A Court case

After a wedding in 20X1-20X2, ten people died, possibly as a result of food poisoning from products sold by the entity. Legal proceedings are started seeking damages from the entity but it disputes liability.

Up to the date of approval of the financial statements for the year to31 March 20X2 for issue, the entity's lawyers advise that it is probable that the entity will not be found liable.

However, when the entity prepares the financial statements for the year to 31 March 20X3, its lawyers advise that, owing to developments in the case, it is probable that the entity will be found liable. It is assumed that a reliable estimate can be made of any outflows expected.

(a) At 31 March 20X2

Present obligation as a result of a past obligating event – On the basis of the evidence available when the financial statements were approved, there is no obligation as a result of past events.

Conclusion – No provision is recognised. The matter is disclosed as a contingent liability unless the probability of any outflow is regarded as remote.

(b) At 31 March 20X3

Present obligation as a result of a past obligating event – On the basis of the evidence available, there is a present obligation.

An outflow of resources embodying economic benefits in settlement – Probable.

Conclusion – A provision is recognised for the best estimate of the amount to settle the obligation.

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Example 2: Warranty

A manufacturer gives warranties at the time of sale to purchasers of its product. Under the terms of the contract for sale the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that become apparent within three years from the date of sale.

On past experience, it is probable (i.e., more likely than not) that there will be some claims under the warranties. It is assumed that a reliable estimate can be made of any outflows expected.

Present obligation as a result of a past obligating event – The obligating event is the sale of the product with a warranty, which gives rise to a legal obligation.

An outflow of resources embodying economic benefits in settlement – Probable for the warranties as a whole.

Conclusion – A provision is recognised for the best estimate of the costs of making good under the warranty products sold before the end of the reporting period.

12 Significant differences in IND AS 37 & AS 29

Basis of differences	IND AS 37	AS 29
Definition Constructive Obligations, Provision and Obligating Event	Specifically defines "constructive obligation". A provision is a liability uncertain amount or timing. Specifically talks about obligating event.	doesn't define specifically. Provision is a liability which can be measured only by using substantial degree of estimation. Doesn't talk about obligating event.
Discounting	When the effect of time value of money is material, discounting is required.	Discounting is not permitted except for decommissioning, restoration and similar liabilities associated with PPE
Contingent asset	Not recognised but disclosed in the financial statements when an inflow of economic benefits is probable.	Neither recognised nor disclosed in the financial statements and are usually disclosed in the report of the approving authority.
Onerous Contracts	Makes it clear that before a separate provision for an onerous contract is established, an entity should recognise any impairment loss that has occurred on assets dedicated to that contract in accordance with Ind AS 36.	There is no such specific provision
Additional guidance	gives guidance on: (a) Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds (b) Liabilities arising from Participating in a Specific Market	Does not give such guidance.

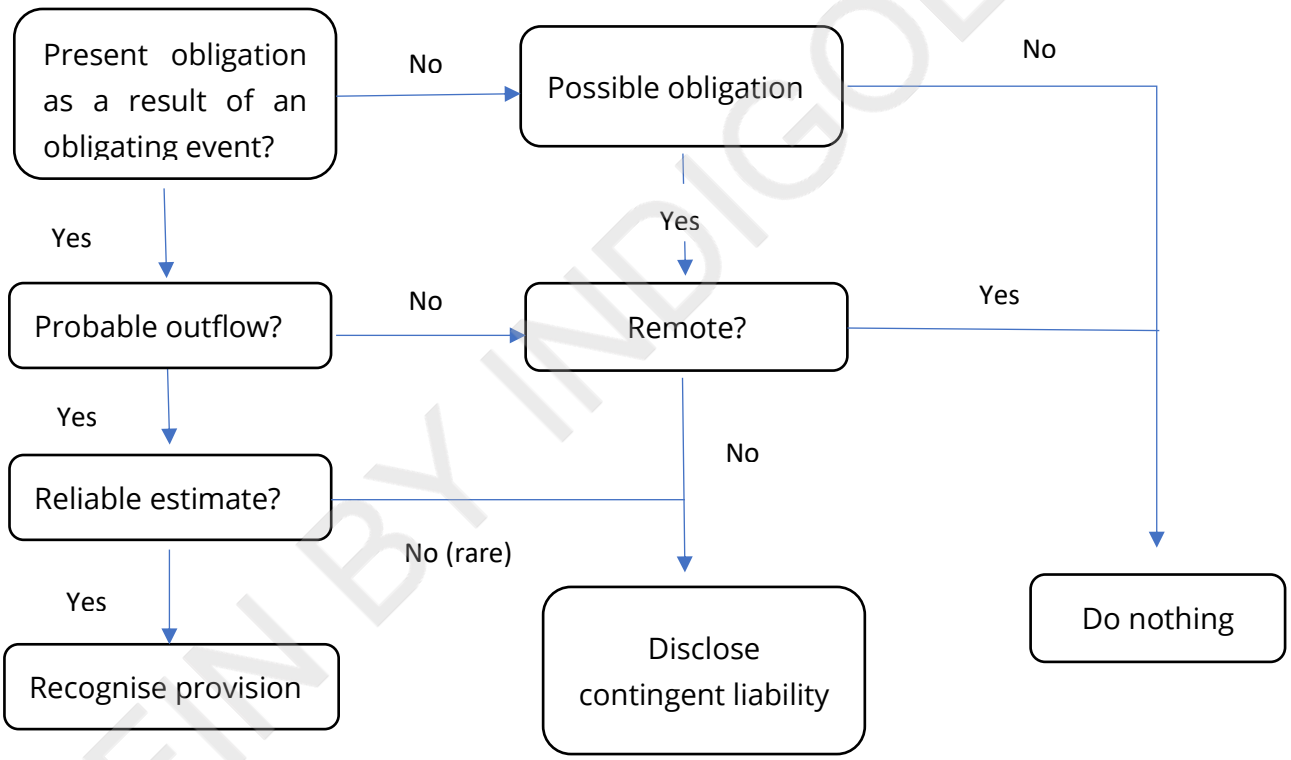
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	— Waste Electrical and Electronic Equipment (c) Levies (imposed by government).	

- The amount of a provision should be the **present value** of the expenditures expected to be required to settle the obligation.
- The discount rate should be a **pre-tax rate.**

13 Summary

Decision tree:



Important Points:

*No provision is recognised for costs that need to be incurred by an entity to operate **in the future.***

*Only those obligations arising from past events existing independently of an entity's future actions (i.e., the future conduct of its business) **that should be recognised as provisions***

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The entity can avoid the future expenditure by its future actions. In such a case, it has no present obligation for that future expenditure and no provision is recognised.

Provisions should not be recognised for future operating losses as future operating losses do not meet the definition of a liability

Gains on the expected disposal of assets should not be taken into account in measuring a provision

- Provisions should be reviewed at the end of each reporting period and adjusted to reflect the current best estimate.
- Provision should be reversed, if it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation

ILLUSTRATIONS

1. Illustration

X Ltd. is engaged in the manufacture of fertilisers. Effluents discharged in the manufacturing process have polluted the river near the manufacturing plant. The residents of the nearby locality launched a massive agitation against the pollution. X Ltd. agreed to their demands to reduce the water pollution by installing the necessary Effluent Treatment Plant. However, during the year no steps are taken to install the plant. No legislation requiring the company to reduce its pollution is in existence.

2. Illustration

ABC Limited is an automobile component manufacturer. The automobile manufacturer has specified a delivery schedule, non-adherence to which will entail a penalty. As on 31st March, 20X1, the reporting date, the manufacturer has a delivery scheduled for June 20X2. However, the manufacturer is aware that he will not be able to meet the delivery schedule in June 20X2.

Determine whether the entity has a present obligation as at 31st March, 20X1, requiring recognition of provision.

3. Illustration

The government introduces a number of changes to the income tax system. As a result of these changes, an entity in the financial services sector will need to retrain a large proportion of its administrative and sales workforce in order to ensure continued compliance with financial services regulation. At the end of the reporting period, no retraining of staff has taken place. It is assumed that a reliable estimate can be made of any outflows expected.

Should the provision be recognised?

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4. Illustration

Under new legislation, an entity is required to fit smoke filters to its factories by September 30, 20X1. The entity has not fitted the smoke filters till March 31, 20X2. It is assumed that a reliable estimate can be made of any outflows expected. Should the provision be recognised?

5. Illustration

A furnace has a lining that needs to be replaced every five years for technical reasons. At the end of the reporting period, the lining has been in use for three years. It is assumed that a reliable estimate can be made of any outflows expected. Should the provision be recognised?

6. Illustration

An airline is required by law to overhaul its aircraft once every three years. It is assumed that a reliable estimate can be made of any outflows expected. Should the provision be recognised?

7. Illustration

X Shipping Ltd. is required by law to overhaul its shipping fleet once in every 3 years. The company's finance team was of the view that recognising the costs only when paid would prevent matching of revenue earned all the time with certain costs of large amounts which are incurred occasional. Thereby, it has formulated an accounting policy of providing in its books of account for the future cost of maintenance (overhauls, annual inspection etc.) by calculating a rate per hours sailed on sea and accumulating a provision over time. The provision is adjusted when the expenditure is actually incurred. Is the accounting policy of X Shipping Ltd. correct?

8. Illustration

An entity operates an offshore oilfield where its licensing agreement requires it to remove the oil rig at the end of production and restore the seabed. 90% of the eventual costs relate to the removal of the oil rig and restoration of damage caused by building it, and 10% arise through the extraction of oil. At the end of the reporting period, the rig has been constructed but no oil has been extracted. It is assumed that a reliable estimate can be made of any outflows expected.

9. Illustration

After a wedding in 20X1-20X2, ten people died, possibly as a result of food poisoning from products sold by the entity. Legal proceedings are started seeking damages from the entity but it disputes liability. Up to the date of approval of the financial statements for the year to 31 March 20X2 for issue, the entity's lawyers advise that it is probable that the entity will not be found liable. However, when the entity prepares the financial statements for the year to 31 March 20X3, its lawyers advise that, owing to developments in the case, it is probable that the entity will be found liable. It is assumed that a reliable estimate can be made of any outflows expected. Should the provision be recognised?

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10. Illustration

An entity sells goods with a warranty under which customers are covered for the cost of repairs of any manufacturing defects that become apparent within the first six months after purchase. If minor defects were detected in all products sold, repair costs of ₹ 1 million would result. If major defects were detected in all products sold, repair costs of ₹ 4 million would result. The entity's past experience and future expectations indicate that, for the coming year, 75% of the goods sold will have no defects, 20% of the goods sold will have minor defects and 5% of the goods sold will have major defects. In accordance with the standard, an entity assesses the probability of an outflow for the warranty obligations as a whole.

11. Illustration

An entity faces a single legal claim, with a 40 per cent likelihood of success with no cost and a 60 percent likelihood of failure with a cost of ₹ 1 million. Expected value is not valid in this case because the outcome will never be a cost of ₹ 600,000 (60 percent × ₹ 1 million); the outcome will either be nil or ₹ 1 million. Ind AS 37 indicates that the provision may be estimated at the individual most likely outcome. In this example, it is more likely that a cost of ₹ 1 million will result and, therefore, a provision for ₹ 1 million should be recognised.

12. Illustration

X Solar Power Ltd., a power company, has a present obligation to dismantle its plant after 35 years of useful life. X Solar Power Ltd. cannot cancel this obligation or transfer to third party. X Solar Power Ltd. has estimated the total cost of dismantling at ₹ 50,00,000, the present value of which is ₹ 30,00,000. Based on the facts and circumstances, X Solar Power Ltd. considers the risk factor of 5% i.e., the risk that the actual outflows would be more from the expected present value. How should X Solar Power Ltd. account for the obligation?

13. Illustration

ABC Ltd. has an obligation to restore the seabed for the damage it has caused in the past. It has to pay ₹ 10,00,000 cash on 31st March 20X3 relating to this liability. ABC Ltd.'s management considers that 5% is an appropriate discount rate.

Calculate the amount to be provided for at 31st March 20X1 for the costs of restoring the seabed.

14. Illustration

At the end of 20X1, an entity is demonstrably committed to the closure of some facilities, having drawn up a detailed plan and made appropriate announcements. The expected impact of the plan is as follows:

	20X2	20X3
Committed closure costs	₹ 10,00,000	
Gain from sale of property		₹ 2,00,000

The provision required at the end of 20X1 is ₹ 10,00,000 (ignoring discounting). The expected gain on the sale of the property is dealt with separately under the derecognition criteria in Ind AS 16.

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15. Illustration

X Beauty Solutions Ltd. is selling cosmetic products under its brand name 'B', but it is getting its product manufactured from Y Ltd. It has an understanding (enforceable agreement) with Y Ltd. that if the company becomes liable for any damage claims, due to any injury or harm to the customer of the cosmetic products, 30% will be reimbursed to it by Y Ltd. During the financial year 20X1-20X2, a claim of ₹ 30,00,000 becomes payable to customers by X Beauty Solutions Ltd. How should X Beauty Solutions Ltd. account for the claim that becomes payable?

16. Illustration

An entity has a contract to purchase one million units of gas at 23p per unit, giving a contract price of ₹ 2,30,000. The current market price for a similar contract is 16p per unit, giving a price of ₹ 1,60,000. The gas will be used to generate electricity, which will be sold at a profit. Is this an onerous contract?

17. Illustration

An entity has a contract to purchase one million units of gas at 23p per unit, giving a contract price of ₹ 2,30,000. The current market price for a similar contract is 16p per unit, giving a price of ₹ 1,60,000. What if electricity sold at a loss?

18. Illustration

An entity has a contract to purchase one million units of gas at 23p per unit, giving a contract price of ₹ 2,30,000. The current market price for a similar contract is 16p per unit, giving a price of ₹ 1,60,000. Assume the entity sells the gas under contract, which it no longer needs, to a third party for 18p per unit. The entity determines that it would have to pay ₹ 55,000 to exit the purchase contract. What is the provision to be made?

19. Illustration

X Sugars Ltd. has entered into a sale contract of ₹ 3,00,00,000 with Y Chocolates Ltd. for the supply of sugar during 20X1-20X2. As per the contract the delivery is to be made within 2 months from the date of contract.

In case of failure to deliver within the schedule, X Sugars Ltd. has to pay a compensation of ₹ 30,00,000 to Y Chocolates Ltd.

During the transit, the vehicle carrying the sugar met accident and X Sugar Ltd. lost the entire consignment.

It is, however covered by an insurance policy.

According to the report of the surveyor, the amount is collectible, subject to the deductible clause [i.e., 15% of the claim] in the insurance policy.

The cost of goods lost was ₹ 2,50,00,000.

Before the financial year end, X Sugars Ltd. received informal information from the insurance company that their claim had been processed and the payment had been dispatched for 85% of the claim amount. Meanwhile Y Chocolates Ltd. has made demand of ₹ 30,00,000 since the goods were not delivered on time.

What provision or disclosure would X Ltd. need to make at year end?

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20. Illustration

The annual reporting period of ABC Ltd. ends on March 31. As per the legislation of the State government, a levy is imposed on ABC Limited in full when it generates revenue in financial year 2016-17. The levy imposed by the government is calculated by reference to revenue generated by ABC Ltd. in previous financial year. ABC Ltd. had generated revenue of ₹ 200 crores in financial year 2015-16. For financial year 2016-17, it starts to generate revenue on April 5, 2016.

ABC Ltd. paid the levy on July 10, 2016. What is the obligatory event that gives rise to recognition of a liability to pay a levy in the present case?

What are the principles for recognising the levy in the annual financial statements and interim financial report?

21. Illustration

X Ltd. is operating in the telecom industry. During the Financial Year 20X1-20X2, the Income Tax authorities sent a scrutiny assessment notice under Section 143(2) of the Income-tax Act, 1961, in respect to return filed under Section 139 of this Act for Previous Year 20X0-20X1 (Assessment Year 20X1-20X2) and initiated assessment proceedings on account of a deduction claimed by the company which in the view of the authorities was inadmissible.

During the financial year 20X1-20X2 itself, the assessment proceedings were completed and the assessing officer did not allow the deduction and raised a demand of ₹ 1,00,00,000 against the company. The company contested such levy and filed an appeal with the Appellate authority. At the end of the financial year 20X1-20X2, the appeal had not been heard. The company is not confident whether that the company would win the appeal. However, the company was advised by its legal counsel that on a similar matter, two appellate authorities of different jurisdictions had given conflicting judgements, one in favour of the assessee and one against the assessee. The legal counsel further stated it had 50% chance of winning the appeal. Please advise how the company should account for these transactions in the financial year 20X1-20X2.

22. Illustration

Entity A is a dealer in washing machines. Entity A offers to its customers a scheme whereby it states that after a period of 3 years, the entity offers to buy back the washing machine at a fixed price which is expected to be less than the fair value of the machine at the end of three years. The credit emanating therefrom will be required to be used by the customer for buying a new washing machine, i.e., new washing machine will be sold at a discounted price. Past experience indicates that customers generally opt for this scheme. At the time of sale of the first washing machine should entity A recognise any provision in this regard?

23. Illustration

U Ltd. is a large conglomerate with a number of subsidiaries. It is preparing consolidated financial statements as on 31st March 20X2 as per the notified Ind AS. The financial statements are due to be approved for issue on 15th May 20X2. Following are a few transactions that have taken place in some of its subsidiaries during the year:

G Ltd. is a wholly-owned subsidiary of U Ltd. engaged in management consultancy services. On 31st January 20X2, the board of directors of U Ltd. decided to discontinue the business of G Ltd. from 30th April 20X2. They made a public announcement of their decision on 15th February 20X2.

G Ltd. does not have many assets or liabilities and it is estimated that the outstanding trade receivables and payables would be settled by 31st May 20X2. U Ltd. would collect any amounts still

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owed by G Ltd.'s customers after 31st May 20X2. They have offered the employees of G Ltd. termination payments or alternative employment opportunities.

Following are some of the details relating to G Ltd.:

- On the date of public announcement, it is estimated by G Ltd. that it would have to pay ₹ 540 lakhs as termination payments to employees and the costs for relocation of employees who would remain with the Group would be ₹ 60 lakhs. The actual termination payments totalling to ₹ 520 lakhs were made in full on 15th May 20X2. As per latest estimates made on 15th May 20X2, the total relocation cost is ₹ 63 lakhs.

- G Ltd. had taken a property on operating lease, which was expiring on 31st March 20X6. The present value of the future lease rentals (using an appropriate discount rate) is ₹ 430 lakhs. On 15th May 20X2, G Ltd. made a payment to the lessor of ₹ 410 lakhs in return for early termination of the lease.

The loss after tax of G Ltd. for the year ended 31st March 20X2 was ₹ 400 lakhs. G Ltd. made further operating losses totalling ₹ 60 lakhs till 30th April 20X2.

What are the provisions that the Company is required to make as per Ind AS 37?

24. Illustration

A company manufacturing and supplying process control equipment is entitled to duty draw back if it exceeds its turnover above a specified limit. To claim duty drawback, the company needs to file application within 15 days of meeting the specified turnover. If application is not filed within stipulated time, the Department has discretionary power of giving duty draw back credit. For the year 20X1-20X2 the company has exceeded the specified limit of turnover by the end of the reporting period. However, duty drawback can be claimed on filing of application within the stipulated time or on discretion of the Department if filing of application is late. The application for duty drawback is filed on April 20, 20X2, which is after the stipulated time of 15 days of meeting the turnover condition. Duty drawback has been credited by the Department on June 28, 20X2 and financial statements have been approved by the Board of Directors of the company on July 26, 20X2. What would be the treatment of duty drawback credit as per the given information?

25. Illustration

Entity XYZ entered into a contract to supply 1000 television sets for ₹ 2 million. An increase in the cost of inputs has resulted into an increase in the cost of sales to ₹ 2.5 million. The penalty for non-performance of the contract is expected to be ₹ 0.25 million. Is the contract onerous and how much provision in this regard is required?

26. Illustration

Marico has an obligation to restore environmental damage in the area surrounding its factory. Expert advice indicates that the restoration will be carried out in two distinct phases; the first phase requiring expenditure of ₹ 2 million to remove the contaminated soil from the area and the second phase, commencing three years later from the end of first phase, to replant the area with suitable trees and vegetation. The estimated cost of replanting is ₹ 3.5 million. Marico uses a cost of capital (before taxation) of 10% and the expenditure, when incurred, will attract tax relief at the company's marginal tax rate of 30%. Marico has not recognised any provision for such costs in the past and today's date is 31 March 20X2. The first phase of the clean up will commence in a few months time and will be completed on 31 March 20X3 when the first payment of ₹ 2 million will be made. Phase 2 costs will be paid three years later from the end of first phase. Calculate the amount to be provided at 31 March 20X2 for the restoration costs.

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27. Illustration

Sun Limited has entered into a binding agreement with Moon Limited to buy a custom-made machine for ₹ 4,00,000. At the end of 2O17-18, before delivery of the machine, Sun Limited had to change its method of production. The new method will not require the machine ordered which is to be scrapped after delivery. The expected scrap value is nil. Given that the asset is yet to be delivered, should any liability be recognized for the potential loss? If so, give reasons for the same, the amount of liability as well as the accounting entry.

28. Illustration

Mini Ltd. took a factory premises on lease on 1.4.2016 for ₹ 2,00,000 per month. The lease is operating lease. During March 2017, Mini Ltd. relocates its operation to a new factory building.The lease on the old factory premises continues to be live up to 31.12.2019.The lease cannot be cancelled and cannot be sub-let to another user. The auditor insists that lease rent of balance 33 months up to 31.12.2019 should be provided in the accounts for the year ending 31.3.2017. Mini Ltd. seeks your advice.

29. Illustration

Vishnu Company has at its financial year ended 31st March, 2017, fifteen law suits outstanding none of which has been settled by the time the accounts are approved by the directors.

The directors have estimated the possible outcomes as below:

Result	Probability	Amount of loss
For first ten cases		
Win	0.6	
Loss-low damages	0.3	90,000
Loss-High damages	0.1	1,60,000
For remaining five cases		
Win	0.5	
Loss-low damages	0.3	60,000
Loss-High damages	0.2	95,000

The directors believe that the outcome of each case is independent of the outcome of all the others. Estimate the amount of contingent loss and state the accounting treatment of such contingent loss.

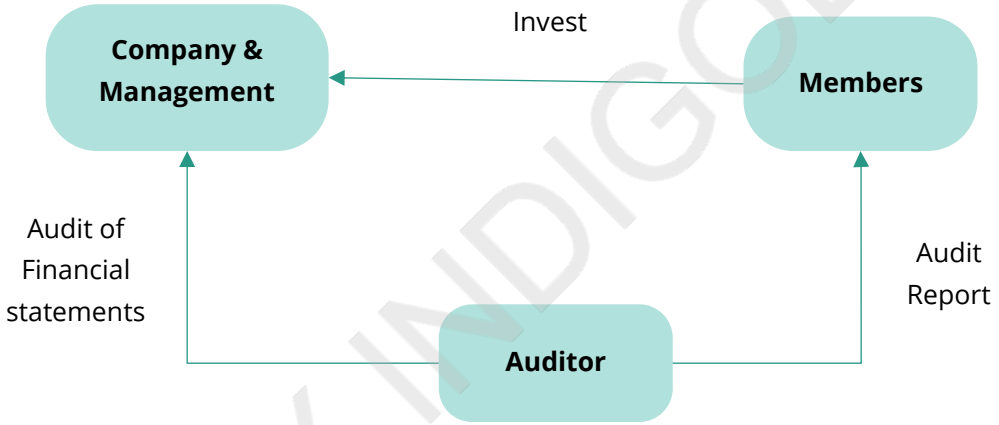
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1. Audit Background – For a Company

- In a company form of organization, the Ownership and Management is different.
- Management of the company prepares financial statements and presents to the members.
- The members are not allowed to interfere in the day-to-day business of the company.
- It is also not practically possible for the members to scrutinize and get into the details of the financial statements.
- Members of the company appoint an auditor to check the financial statements prepared by the management of the company.
- Auditor examines and audits the books of the company, and presents an ***Audit report*** to the members.
- The Auditor reports to the members through an ***Audit Report***.

1.1. The Game of Auditing

1.2 ORIGIN OF AUDITING



- Auditing has existed even in ancient times in many societies of world including India.
- The reference to auditing is found in Kautilya's Arthshastra even in 4th century BC. It talks about fixed accounting year, a process for closure of accounts and audit for the same.
- Concepts of periodical checking and verification existed even in those times. Even there are references in his monumental work to misstatements in financial statements due to abuse of power
- The word "audit" originates from Latin word "audire" meaning "to hear". In medieval times, auditors used to hear the accounts read out to them to check that employees were not careless and negligent.
- Coming to more recent history, the first Auditor General of India was appointed in British India in 1860 having both accounting and auditing functions.
- Later on, office of Auditor General was given statutory recognition. Presently, Comptroller and Auditor General of India is an independent constitutional authority responsible for auditing government receipts and expenditures.
- The Institute of Chartered Accountants of India was established as a statutory body under an Act of Parliament in 1949 for regulating the profession of Chartered Accountancy in the country.

1.3 Meaning and Nature of Auditing

"Audit is an ***independent examination*** of ***financial information*** of ***any entity***, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to express an ***opinion*** thereon."

- **Independent examination** – implies the judgement of a person is not subordinate to the wishes or direction of another person who might have engaged him.

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- **Financial information** – The financial statements and accounts of the entity
- **Any entity** – whether profit oriented or not and irrespective of its size or legal form. It could be firm, LLP Company etc.
- **Opinion thereon (objective)** – Auditing gives a reasonable assurance that the financial statements are prepared properly, and they are not misleading.

The person conducting this task should take care to ensure that financial statements would not mislead anybody. This he can do honestly by satisfying himself that:

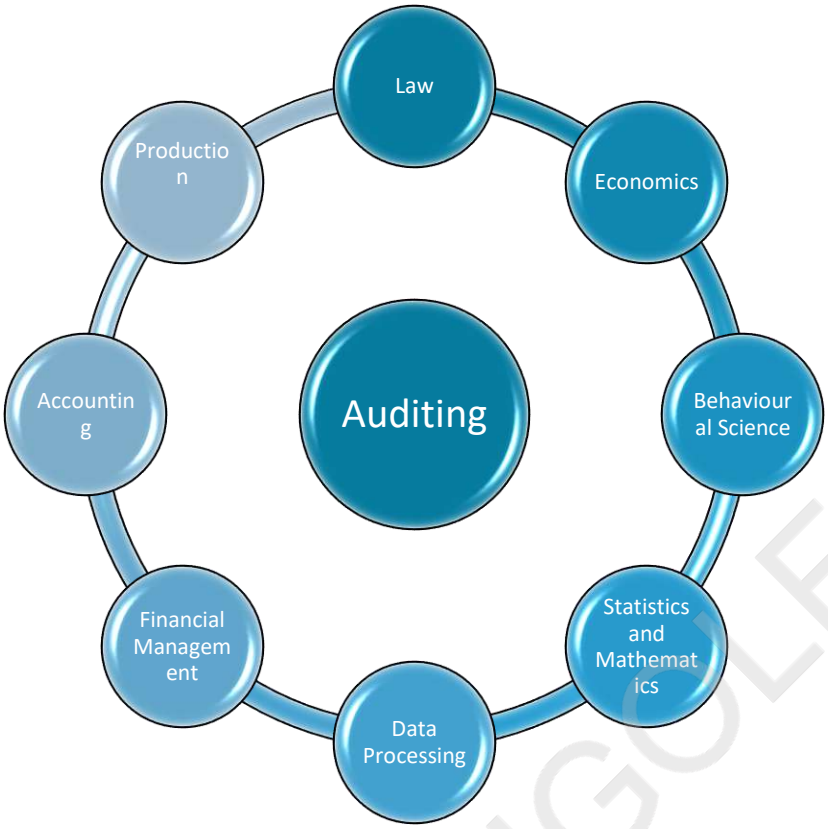
- the accounts have been drawn up with reference to entries in the books of account
- the entries in the books of account are adequately supported by sufficient and appropriate evidence
- none of the entries in the books of account has been omitted in the process of compilation and nothing which is not in the books of account has found place in the statements
- the information conveyed by the statements is clear and unambiguous
- the financial statement amounts are properly classified, described and disclosed in conformity with accounting standards; and
- the statement of accounts presents a true and fair picture of the operational results and of the assets and liabilities.

1. **Auditing provides assurance.**
2. **Its basic nature lies in providing assurance to users - providing confidence to users of financial statements.**
3. **Such an assurance lends credibility to financial statements.**
4. **Audited financial statements provide confidence to users that financial information reflected in financial statements can be relied upon.**

2. INTERDISCIPLINARY NATURE OF AUDITING- RELATIONSHIP WITH DIVERSE SUBJECTS

- Auditing is interdisciplinary in nature.
- It draws from diverse subjects including accountancy, law, behavioural science, statistics, economics and financial management and makes use of these subjects.

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Auditing and Accounting: Auditing reviews the financial statements which are nothing but a result of the overall accounting process.
Auditing and Law: An auditor should have a good knowledge of business laws affecting the entity.
Auditing and Economics: Auditor is expected to be familiar with the overall economic environment of the client.
Auditing and Behavioural Science: Knowledge of human behaviour is essential for an auditor to effectively discharge his duties.
Auditing and Statistics & Mathematics: Auditor is also expected to have the knowledge of statistical sampling for meaningful conclusions and mathematics for verification of inventories.
Auditing and Data Processing: EDP auditing in itself is developing as a discipline in itself.
Auditing and Financial Management : Auditor is expected to have knowledge about various financial techniques such as working capital management, funds flow, ratio analysis, capital budgeting etc.
Auditing and Production: Good auditor is one who understands the client and his business functions such as production, cost system, marketing etc.

Conclusion

- Auditing as a discipline is also closely related with various other disciplines as there is lot of linkages in the work which is done by an auditor in his day-to-day activities.
- The knowledge of language is also considered essential in the field of auditing as the auditor shall be required to communicate, both in writing as well as orally, in day-to-day work.
- Auditing is also closely related with other functional fields of business such as finance, production, marketing, personnel, and other general areas of business management.

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3. Overall Objective of the Auditor

In conducting audit of financial statements, objectives of auditor in accordance with SA-200 *"Overall Objectives of the Independent auditor and the conduct of an audit in accordance with Standards on Auditing*" are: -

(a) To obtain **reasonable assurance** about whether the financial statements as a whole are **free from material misstatement**, whether due to fraud or error, thereby enabling the **auditor to express an opinion** on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and

(b) **To report on the financial statements**, and **communicate** as required by the SAs, in accordance with the auditor's findings.

An analysis of above brings out following points clearly: -

- The opinion on financial statements which is a ***good indicator of the correct position*** of the business entity is called appropriate audit opinion.
- The auditor is required to give an appropriate audit opinion ***after conducting the audit***.
- To give an appropriate audit opinion, the auditor has to be
  - **Independent** – The Auditor's opinion should be ***unbiased***.
  - **Unbiased** – It is not influenced by any ***prior perception*** of the auditor. Conclusion should be based on the evidences obtained.
  - **Knowledgeable** – He should gain knowledge of the relevant business to be able to form a correct opinion.

3.1 Reasonable Assurance

- It is the ***best assurance*** that the auditor can give. He cannot give a 100% assurance (absolute assurance) as the audit is subject to certain inherent limitations.
- Thus, reasonable assurance is the assurance given to the best of his ability and with the information made available.
- Reasonable assurance is to be distinguished from absolute assurance. Absolute assurance is a complete assurance or a guarantee that financial statements are free from material misstatements.
- However, reasonable assurance is not a complete guarantee. Although it is a high-level of assurance but it is not complete assurance.

3.2 Material Misstatement

A ***significant mistake*** in the financial statements. An item is called material if it has the ability to change the decision of the user. Auditor fixed materiality at the time of planning the audit.

3.3 Fraud And Error

Error is an ***unintentional*** mistake. Something which has happened inadvertently. But fraud is ***deliberate*** and intentional mistake.

3.4 Financial Reporting Framework

- It is the ***format*** in which the financial statements should be prepared and presented. The ***laws governing different types of entities*** will provide such format.
  - For companies – The Companies Act 2013 prescribes the format
  - For Banks – RBI's regulations provide the format
  - For Insurance companies – IRDA provides the format etc.
- Thus, the ***management must prepare*** its financial statements as per the prescribed format only. The auditor has to report on the compliance of the same.
- There are two types of frameworks- Fair Presentation Framework and Compliance Framework

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3.5 Audit Evidence

Information collected during the audit, based on which the audit opinion is formed is called audit evidence.

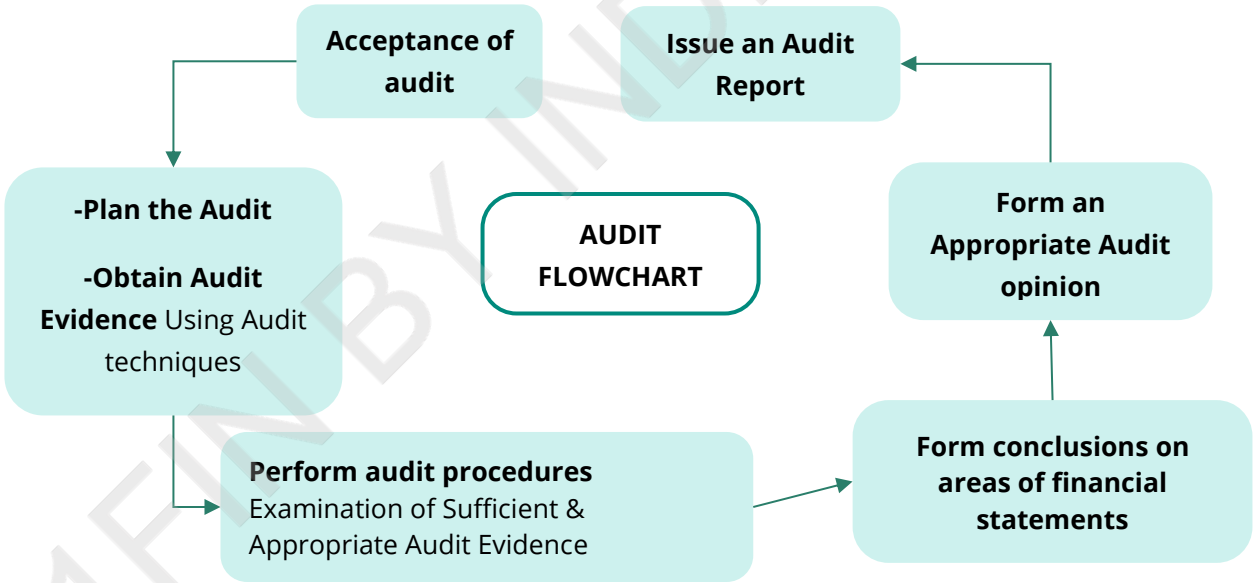
3.6 Reporting

The opinion is reported and communicated in accordance with audit findings through a written report as required by Standards on Auditing. (SA 700 series)

An overview of Objective of Auditor
• Obtaining a reasonable assurance that financial statements as a whole are free from material misstatement due to fraud or error
• Gaining a reasonable assurance leads to formation of opinion whether financial statements are prepared, in all material respects, in accordance with applicable financial reporting framework
• To report on the financial statements
• Reporting of opinion in accordance with audit findings
• Communication of reporting
• Reporting and communication in accordance with Standards on Auditing

4. Aspects, Scope of Audit & Role of Management & Auditor

Aspect of Audit: It describes the process from the beginning to end in an audit engagement.



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Role of Management and Auditor

- Management has certain responsibilities towards Members

Maintenance of ***proper books of accounts***
Choosing ***appropriate accounting policies***
Designing ***internal controls in line with size and nature*** of entity
Prevention and early ***detection of fraud and error***
Follow ***fundamental accounting assumptions***
Ensure that financial statements are in line with proper ***financial reporting framework***
Safeguard the assets of the entity

- Management has certain responsibilities towards Auditors

Access to books and records of the entity
Provide information and explanation whenever asked for

- Management is ***primarily responsible for preparation of the Financial statements.***
- The Auditor has to check whether all the responsibilities of Management have been fulfilled or not.
- Statutory Auditor is
  - Appointed by the Members
  - Works for the Members
  - Reports to the Members.

4.1 Scope of Audit

- To form an opinion the auditor should be satisfied that the accounting information is reliable and sufficient as the basis for the preparation of the financial statements.
- All aspects of the enterprise are covered in audit.
- In forming his opinion, the auditor should decide whether the relevant information is properly disclosed in the financial statements.
- The auditor is not expected to perform duties which are outside the scope of his competence. For example, the professional skill required of an auditor does not include that of a technical expert for determining physical condition of certain assets.
- Constraints on the scope of the audit that impair the auditor's ability to express an unqualified opinion should be set out in his report.

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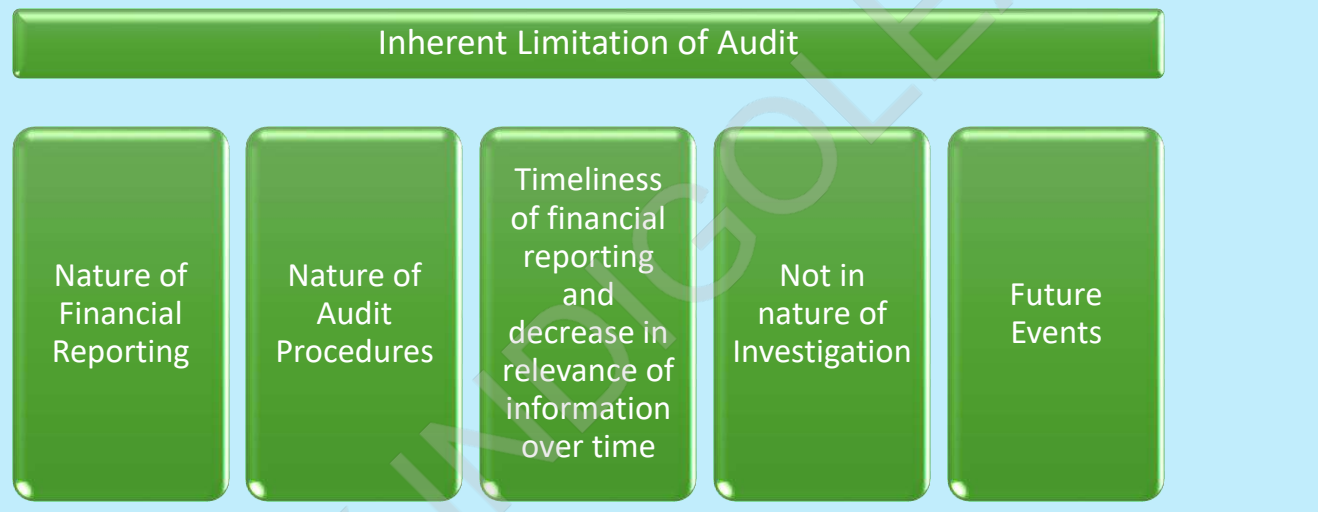
An Overview of Scope of Audit- what Audit Includes

• Coverage of all aspects of entity relevant to the financial statements being audited.
• Reliability and Sufficiency of financial information
• Proper disclosure of financial information
• Expression of an opinion on financial statements

What Audit does not include

• Responsibility of preparation and presentation of financial statements
• Duties outside scope of competence of auditor
• Expertise in authentication of documents
• Investigation

5. Inherent Limitations of Audit



The process of audit suffers from certain inbuilt limitations due to which an auditor cannot obtain an absolute assurance that financial statements are free from misstatement due to fraud or error. These fundamental limitations arise due to the following factors: -

Nature of Financial Reporting

- The preparation of financial statements involves judgment by management in applying the requirements of the entity's applicable financial reporting framework to the facts and circumstances of the entity.
- Sometimes auditor has to satisfy himself with alternative proofs. Hence, Audit is a process of persuasion and not a process of proof.
- Preparations of financial statement calls for estimations in many scenarios like, provision for doubtful debts, estimation of useful life of the asset etc.

Nature of Audit procedures

- Many financial statement items involve subjective decisions or assessments or a degree of uncertainty, and there may be a range of acceptable interpretations or judgments that may be made.
- There is the possibility that management or others may not provide, intentionally or unintentionally, the complete information that is relevant

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- The existence and completeness of related party relationships and transactions may be difficult to identify.
- The auditor is not given specific legal powers, such as the power of search, which may be necessary for such an investigation.

Not in nature of Invetsigation

- Audit is not an official investigation. Hence, auditor cannot obtain absolute assurance that financial statements are free from material misstatements due to frauds or errors

Timelines of financial reporting and decrease in relevance of information over time

- The relevance of information decreases over time and auditor cannot verify each and every matter. Therefore, a balance has to be struck between reliability of information and cost of obtaining it.

Future Events

- Future events or conditions may affect an entity adversely. Adverse events may seriously affect ability of an entity to continue its business.
- The business may cease to exist in future due to change in market conditions, emergence of new business models or products or due to onset of some adverse events.

Therefore, it is in view of above factors, that an auditor cannot provide a guarantee that financial statements are free from material misstatements due to frauds or errors.

6. Engagement

Engagement means an arrangement to do something. In the context of auditing, it means a formal agreement between auditor and client under which auditor agrees to provide auditing services. It takes the shape of engagement letter.

7. External audit engagements

- The purpose of external audit engagements is to enhance the degree of confidence of intended users of financial statements.
- Such engagements are also reasonable assurance engagements.
- For example, in India, companies are required to get their annual accounts audited by an external auditor.
- Even non-corporate entities may choose to have their accounts audited by an external auditor because of benefits of such an audit.

8. Benefits of Audit

- Audited accounts *provide high quality* information. It gives confidence to users that information on which they are relying is qualitative and it is the outcome of an exercise carried out by following Auditing Standards recognized globally.
- In case of companies, shareholders may or may not be involved in daily affairs of the company. The financial statements are prepared by management consisting of directors. As *shareholders are owners of the company, they need an independent mechanism* so that financial information is qualitative and reliable. Hence, their interest is safeguarded by an audit.
- An audit acts as a *moral check* on employees from committing frauds for the fear of being discovered by audit.
- Audited financial statements are helpful to *government authorities for determining tax liabilities.*
- Audited financial statements can be relied upon by *lenders, bankers for making their credit decision*s i.e. whether to lend or not to lend to a particular entity.

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- An audit may also detect *fraud or error* or both.
- An audit reviews existence and operations of various controls operating in any entity. Hence, it is useful at pointing out *deficiencies.*

9. Audit - Mandatory or Voluntary?

- It is not necessary that audit is always legally mandatory.
- There are entities like companies who are compulsorily required to get their accounts audited under law.
- Even non-corporate entities may be compulsorily requiring audit of their accounts under tax laws. It is also possible that some entities like schools may be required to get their accounts audited for the purpose of obtaining grant or assistance from the Government.
- Audit is not always mandatory. Many entities may get their accounts audited voluntarily because of benefits from the process of audit.
- Many such concerns have their internal rules requiring audit due to advantages flowing from an audit.

10. Appointment of Auditor

- Generally, an auditor is appointed by owners or in some cases by constitutional or government authorities in accordance with applicable laws and regulations.
- For example, in case of companies, auditor is appointed by members (shareholders) in Annual General Meeting (AGM).
- However, in case of government companies in India, auditor is appointed by Comptroller and Auditor General of India (CAG), an independent constitutional authority.
- There may be a situation in which auditor may be appointed by a government authority in accordance with some law or regulation. For example, an auditor may be appointed under tax laws by a government authority.

11. Submission of Audit Report

- The outcome of an audit is written audit report in which auditor expresses an opinion.
- The report is submitted to person making the appointment.
- In case of companies, these are shareholders- in case of a firm, to partners who have engaged him.

12. Meaning of Assurance Engagement

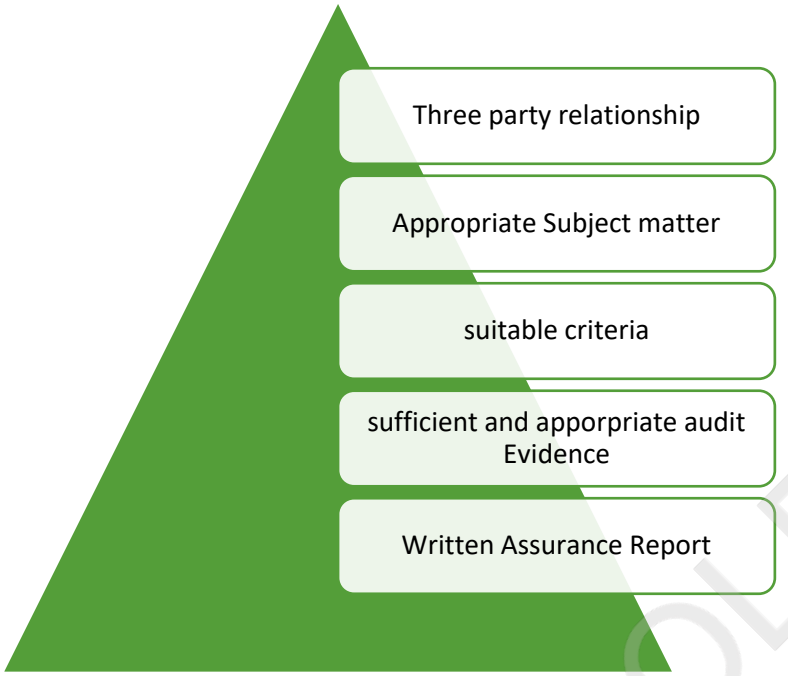
Assurance engagement" means an engagement in which

- a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users
- other than the responsible party
- about the outcome of the evaluation or measurement of a subject matter against criteria.

It means that the practitioner gives an opinion about specific information due to which users of information are able to make confident decisions knowing well that chance of information being incorrect is diminished.

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13. Elements of Assurance Engagement



A three-party relationship involving a practitioner, a responsible party, and intended users

An assurance engagement involves abovesaid three parties.

- A practitioner is a person who provides the assurance. The term practitioner is broader than auditor. Audit is related to historical information whereas practitioner may provide assurance not necessarily related to historical financial information.
- A responsible party is the party responsible for preparation of subject matter.
- Intended users are the persons for whom an assurance report is prepared. These persons may use the report in making decisions.

2. An appropriate subject matter

It refers to the information to be examined by the practitioner. For example, financial information contained in financial statements while conducting audit of financial statements.

3. Suitable criteria

These refer to benchmarks used to evaluate the subject matter like standards, guidance, laws, rules and regulations.

4. Sufficient appropriate evidence

The practitioner performs an assurance engagement to obtain sufficient appropriate evidence. It is on the basis of evidence that conclusions are arrived and an opinion is formed by auditor.

“Sufficient” relates to quantity of evidence obtained by auditor.

“Appropriate” relates to quality of evidence obtained by auditor.

One evidence may be providing more comfort to auditor than the other evidence. The evidence providing more comfort is qualitative and, therefore, appropriate. Evidence should be both sufficient and appropriate.

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5. A written assurance report in appropriate form

A written report is provided containing conclusion that conveys the assurance about the subject matter. A written assurance report is the outcome of an assurance engagement.

14. Meaning of Review: Audit v/s Review

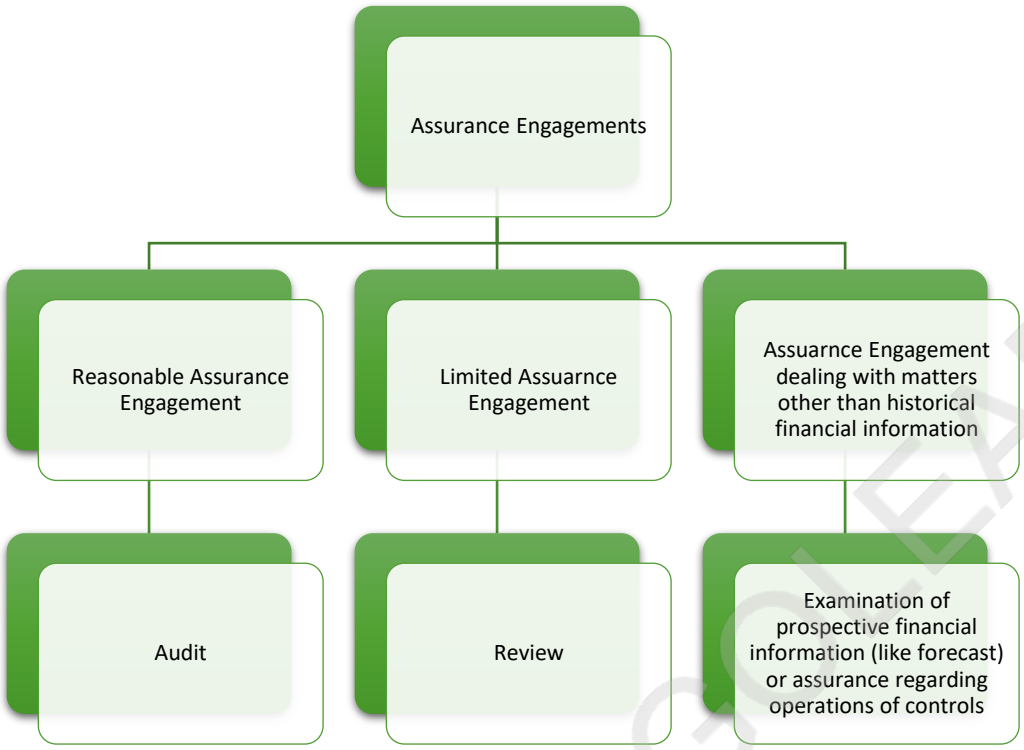
- Audit is a reasonable assurance engagement. It provides reasonable assurance. However, review is a limited assurance engagement.
- It provides lower level of assurance than audit.
- Further, review involves fewer procedures and gathers sufficient appropriate evidence on the basis of which limited conclusions can be drawn up.
- **However, both "audit" and "review" are related to financial statements prepared on the basis of historical financial information.**

15. Types of Assurance Engagements- Reasonable assurance engagement vs. Limited assurance engagement

Reasonable Assurance Engagement	Limited Assurance Engagement
Reasonable assurance engagement provides high level of assurance.	Limited assurance engagement provides lower level of assurance than reasonable assurance engagement.
It performs elaborate and extensive procedures to obtain sufficient appropriate evidence.	It performs fewer procedures as compared to reasonable assurance engagement.
It draws reasonable conclusions on the basis of sufficient appropriate evidence.	It involves obtaining sufficient appropriate evidence to draw limited conclusions.
Example of reasonable assurance engagement is an audit engagement.	Example of limited assurance engagement is review engagement.

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Types of Assurance Engagements



16. Qualities of the Auditor

- ***Tact, caution, firmness, good temper, integrity, discretion, industry, judgement, patience, clear headedness and reliability*** are some ***of*** qualities which an auditor should have.
- In short, all those ***personal qualities*** that go to make a good businessman contribute to the making of a good auditor.
- He must have the ***highest degree of integrity*** backed by adequate independence.
- The auditor, who holds a position of trust, must have the basic human qualities apart from the technical requirement of professional training and education.
- He is called upon constantly to critically review financial statements and it is obviously useless for him to attempt that task unless his **own knowledge is that of an expert.**
- An exhaustive knowledge of accounting in all its branches is a must for the practice of auditing**. He must know thoroughly all accounting principles and techniques.**

17. ENGAGEMENT AND QUALITY CONTROL STANDARDS: AN OVERVIEW

The following Standards issued under authority of ICAI Council are collectively known as Engagement Standards: -

1. Standards on auditing (SAs) which apply in audit of historical financial information.
2. Standards on review engagements (SREs) which apply in review of historical financial information.
3. Standards on Assurance engagements (SAEs) which apply in assurance engagements other than audits and review of historical financial information.
4. Standards on Related Services (SRSs) which apply in agreed upon procedures to information, compilation engagements and other related service engagements.

The purpose of issue of these standards is to establish high quality standards and guidance in the areas of financial statement audits and in other types of assurance services.

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Standards on Auditing (SA)	Standards on Review Engagements (SREs)	Standards on Assurance Engagements (SAEs)	Standards on Related Services (SRSs)

Standards on Auditing

- Standards on Auditing apply in the context of an audit of financial statements by an independent auditor.
- These establish high quality benchmarks and are followed by auditors in conducting audit of financial statements.
- Standards on Auditing have been issued on wide spectrum of issues in the field of auditing ranging from overall objectives of independent auditor, audit documentation, planning an audit of financial statements, identifying and assessing risk of material misstatement, audit sampling, audit evidence and forming an opinion and reporting on financial statements

Classification of SAs

Introductory matters	100-199
General Principles and responsibilities	200-299
Risk assessment and response to assessed risk	300-499
Audit evidence	500-599
Using the work of others	600-699
Audit conclusion and reporting	700-799
Specialized areas	800-899

Standards on Review Engagements

Standards on Review engagements are:

- SRE apply in the context of review of Financial Statements
- Review is a limited assurance engagement and it provides assurance which is lower than that provided by audit. It is due to the fact that review involves fewer procedures as compared to audit.
- Since a review also provides assurance to users, it also involves obtaining sufficient appropriate evidence.
- For example, when an auditor performs review of interim financial information of an entity.

Examples of SREs are:

- SRE 2400 (Revised): Engagements to Review Historical Financial Statements
- SRE 2410: Review of Interim Financial Information Performed by the Independent Auditor of the Entity

SAs and SREs apply to engagements involving historical financial information.

Standards on Assurance Engagements

- Set of standards which apply in assurance engagements dealing with subject matters other than historical financial information.

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- Such assurance engagements do not include "audit" or "review" of historical financial information.
- For example, an assurance engagement relating to examination of prospective financial information.
- In such type of assurance engagements, examination is not of historical financial information or engagement may relate to providing assurance regarding non-financial matters like design and operation of internal control in an entity.

Examples of Standards on Assurance Engagements are:

- SAE 3400 The Examination of Prospective Financial Information
- SAE 3420 Assurance Engagements to Report on the Compilation of Pro Forma Financial Information Included in a Prospectus

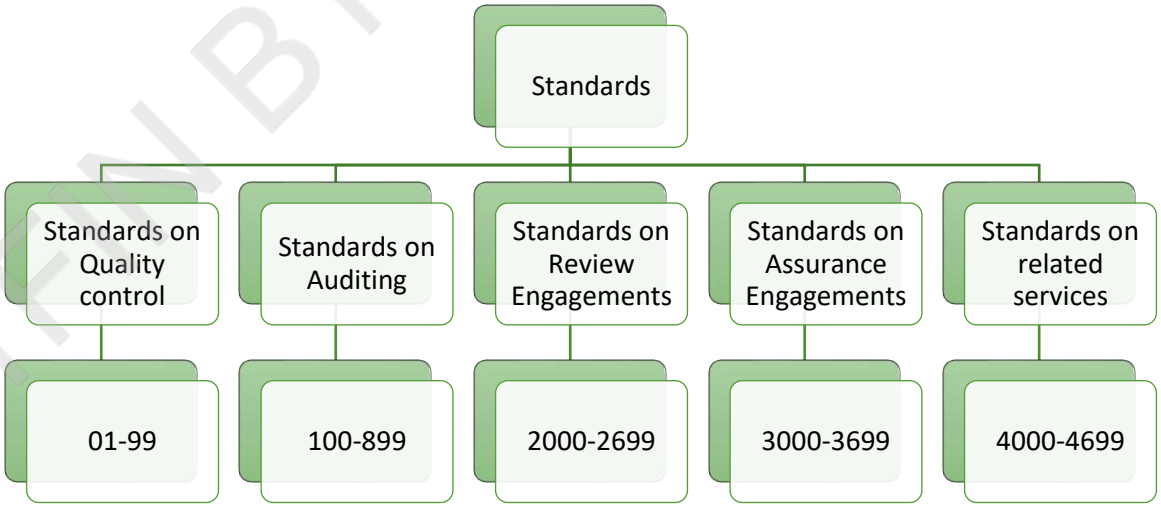
Standards on Related Services

- These standards apply in engagements to perform agreed-upon procedures regarding financial information.
- An engagement in which practitioner may be called upon to assist management with the preparation and presentation of historical financial information without obtaining assurance on that information.
- Such type of compilation engagements fall in the category of related services and practitioner issues a report clearly stating that it is not an assurance engagement and no opinion is being expressed.

- These types of services are called related services and standards have been issued to deal with practitioner's responsibilities in this regard.
  Examples of Standards on related services are:
  - ♦ SRS 4400 Engagements to perform agreed-upon procedures regarding financial information
  - ♦ SRS 4410 (Revised) Compilation engagements

It is to be clearly understood that all the above standards i.e., Standards on Auditing (SAs), Standards on Review Engagements (SREs), Standards on Assurance Engagements (SAEs) and Standards on related services (SRSs) are collectively known as the Engagement Standards.

Numbering of Standards



18. Standards on Quality Control

- Standards on Quality Control (SQCs) have been issued to establish standards and provide guidance regarding a firm's responsibilities for its system of quality control for the conduct of audit and review of historical financial information and for other assurance and related service engagements.

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- ***SQC 1*** has been issued in this regard. It requires auditors/practitioners to establish system of quality control so that firm and its personnel comply with professional standards and regulatory & legal requirements and reports issued are appropriate.
- Its basic objective is that while rendering services, to which engagement standards apply, there should be a system of quality control with in firms to ensure complying with professional standards/legal requirements.
- System of quality control ensures issuing of appropriate reports in the circumstances.

19. Need for Standards

- Standards ensure carrying out of audit against established benchmarks at par with global practices.
- Standards improve quality of financial reporting thereby helping users to make diligent decisions.
- Standards promote uniformity as audit of financial statements is carried out following these Standards.
- Standards equip professional accountants with professional knowledge and skill.
- Standards ensure audit quality.

20. Duties in relation to Engagement and Quality Control Standards

- It is the duty of professional accountants to see that Standards are followed in engagements undertaken by them.
- Ordinarily, these are to be followed by professional accountants.
- However, a situation may arise when a specific procedure as required in Standards would be ineffective in a particular engagement.
- In such a case, he is required to document how alternative procedures performed achieve the purpose of required procedure.
- Also, reason for departure has also to be documented unless it is clear. Further, his report should draw attention to such departures.
- It is also to be noted that a mere disclosure in the report does not absolve a professional accountant from complying with applicable Standards.

SA 200 - Overall Objectives of the Independent Auditor and the conduct of an Audit in accordance with Standards on Auditing

20.1 Introduction

Standards on auditing are written in context of an audit of financial statements by an auditor.

Independent auditor is obliged to comply with all the SAs relevant for the audit of financial statements. They are to be adapted if the circumstances addressed in the SAs exists in the audit.

The auditor is required to have an understanding of the complete SA, with respect to its objectives and application.

SAs do not impose responsibilities on management or those charged with governance and do not override laws and regulations that govern their responsibilities.

20.2 Scope of SA 200

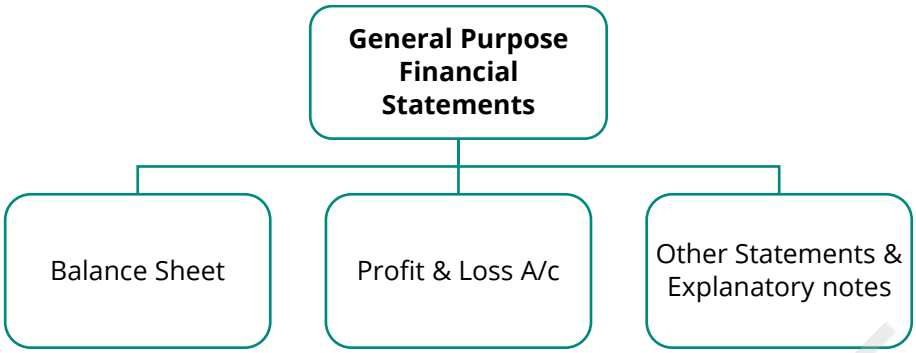
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- Establishing overall responsibilities of Independent Auditor when conducting an audit of financial statements.
- Explains the nature and scope of an audit.
- Scope, authority & structure of Standards on Auditing

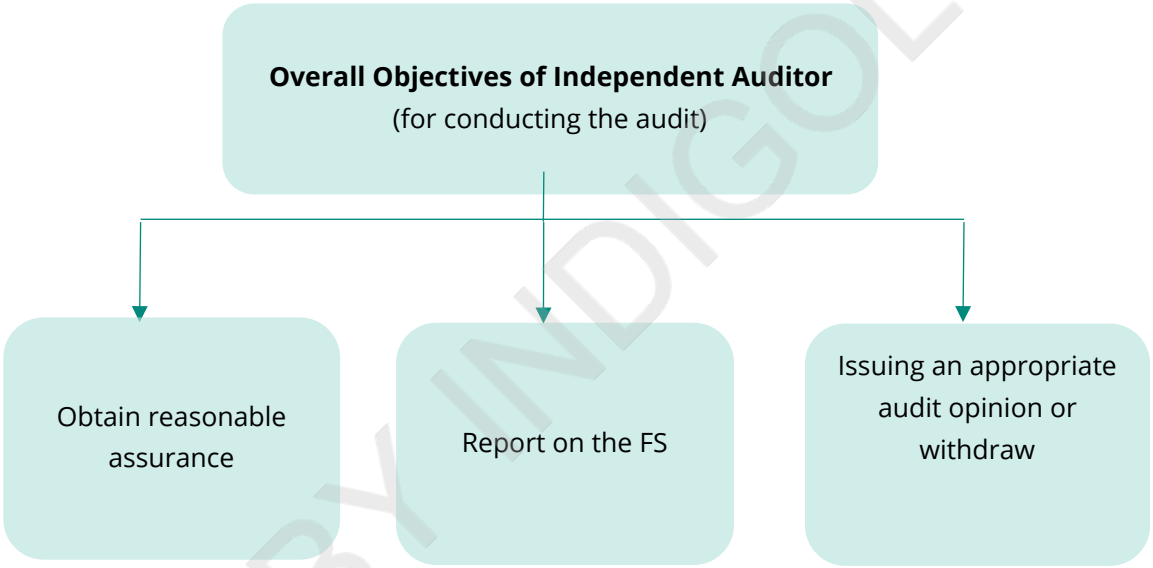
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- General responsibilites which independent auditor should adhere to in all audits.
- Conduct of the audit in accordance with the Standards on Auditing (SA)

20.2.1 General Purpose Financial Statements



20.2.2 Overall objectives of Independent auditor



- To **obtain reasonable assurance** about whether the financial statements as a whole are free from material misstatement, due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework;

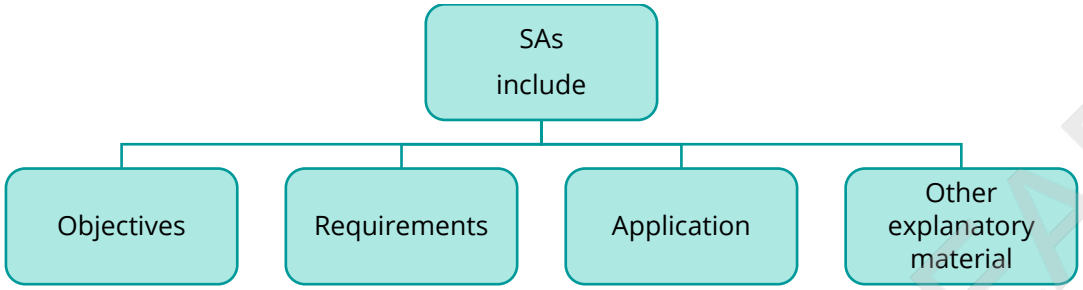
Reasonable assurance is a high level of assurance but is not an absolute level of assurance, because there are inherent limitations of an audit.

- To **report on the financial statements,** and communicate as required by the SAs, in accordance with the auditor's findings.
- **Issuing an appropriate audit opinion** or withdraw from the engagement, if required and legally permitted.

Auditor expresses opinion regarding financial health of the organisation

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When reasonable assurance cannot be obtained and a qualified opinion in the auditor's report is insufficient, auditor can disclaim an opinion or withdraw from the engagement, where withdrawal is legally permitted



These support auditor in obtaining reasonable assurance.

20.2.3 Audit of Financial Statements

Performed by	Auditor for the benefit of members/ intended users
Objective	Enhance degree of confidence of intended users in financial statements
Outcome	Opinion expressed whether or not financial statements prepared as per financial reporting framework give true and fair view
Requirements	Auditor to ensure audit is conducted as per SAs & other ethical requirements

- Financial statements are prepared by the management of the entity and the auditor carries out an audit on such financials to express an opinion whether such financial statements reflect true and fair view of the financial condition of the entity.

Management's Responsibility

The audit of the financial statements does not relieve management or those charged with governance of their

Audit is an independent examination of financial information of an entity with a view to expressing an opinion there on.

responsibilities. Their main responsibilities are:

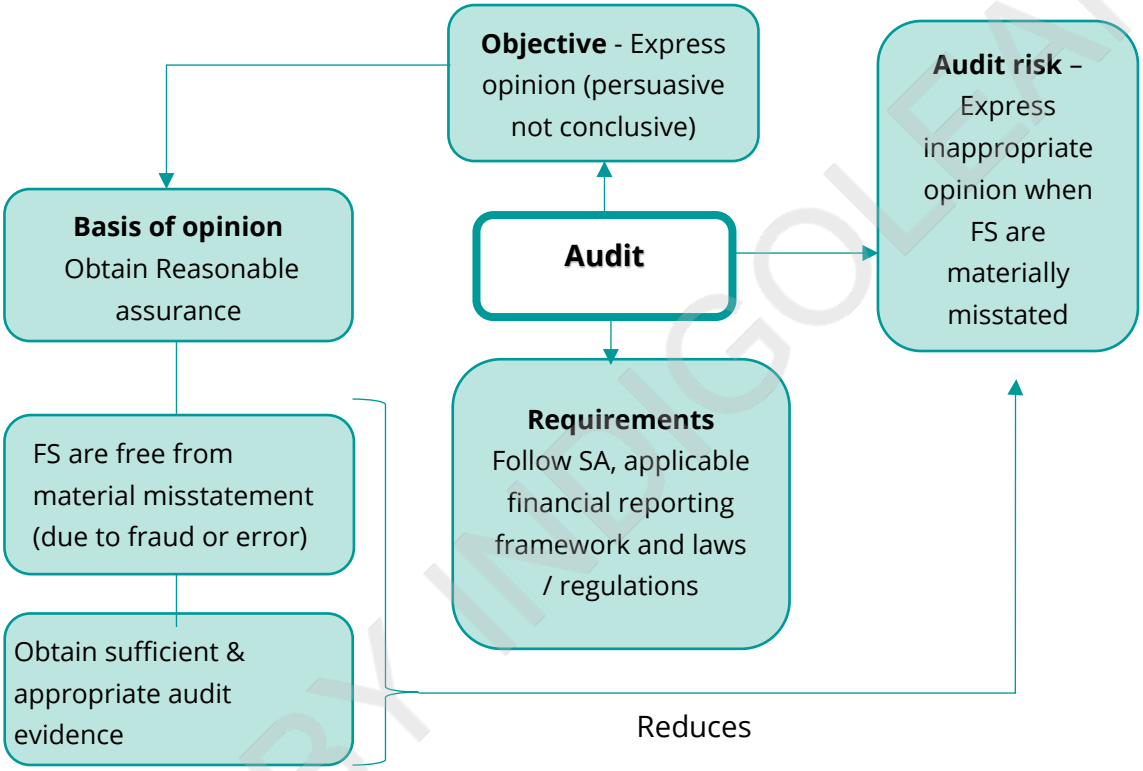
- Maintain adequate accounting records
- Select and apply appropriate accounting policies
- Design internal controls in line with size and nature of the entity

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- Prevent and early detection of fraud and error
- Follow fundamental accounting assumptions
- Preparation of financial statements in accordance with applicable framework
- Safeguard assets

- An audit conducted in accordance with SAs and relevant ethical requirements enables the auditor to form an opinion that financial statements as a whole are free from material misstatement, whether due to fraud or error.

Audit enhances degree of confidence of intended users in the FS.

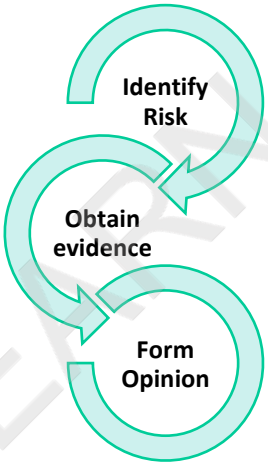


- Auditor shall obtain reasonable assurance, which is the basis for his opinion. Reasonable assurance is a high level of assurance.

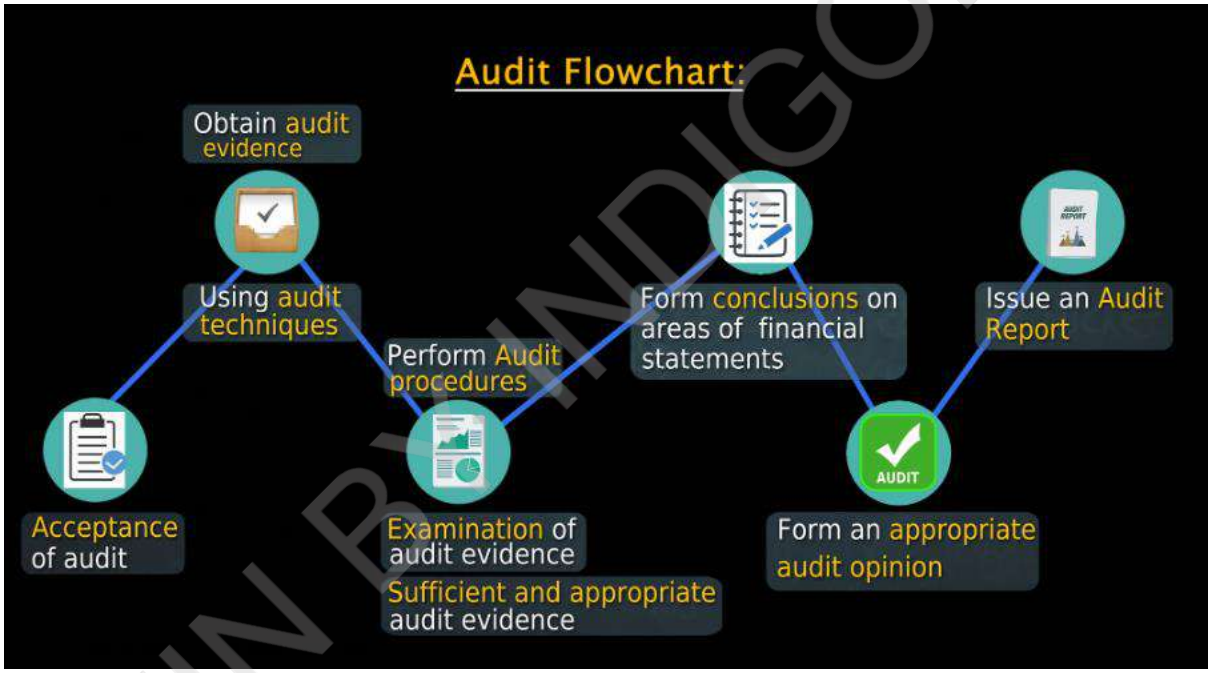
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- **Auditors' approach**

  - Identify and assess **risks of material misstatement**, whether due to fraud or error, based on an understanding of
    - the entity
    - entity's environment,
    - entity's internal control.
  - Obtain **sufficient appropriate audit evidence** about whether material misstatements exist, through designing and implementing appropriate responses to the assessed risks.
  - Form an **opinion on the financial statements** based on conclusions drawn from the audit evidence obtained and will depend upon the applicable financial reporting framework and any applicable laws or regulations.



- The auditor may communicate and report to users, management or others as per SAs or applicable laws or regulations.



20.2.4 Scope of audit

- Statute governing the enterprise
- Pronouncements of ICAI like AS and SAs
- Terms of engagement.

However, terms of engagement can't override the other two

20.3 Concept of True and Fair

The concept of true and fair is a fundamental concept in auditing. The phrase "true and fair" in the auditor's report signifies that the auditor is required to express his opinion as to whether the state of affairs and the results of the entity as ascertained by him in the course of his audit are truly and fairly represented in the accounts under audit. What constitutes a 'true and fair' view is a matter of an auditor's judgment in the particular circumstances of a case. In more specific terms, to ensure true and fair view, an auditor has to see:

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- that the assets are neither undervalued nor overvalued, according to the applicable accounting principles,
- no material asset is omitted
- the charge, if any, on assets are disclosed
- material liabilities should not be omitted
- the profit and loss account and balance sheet disclose all the matters required to be disclosed
- accounting policies have been followed consistently and
- all unusual, exceptional or non-recurring items have been disclosed separately.

20.4 Requirements of an Auditor as per SA 200

SA 200 covers the following major aspects with respect to the requirements an auditor has to fulfil:

- Ethical requirements in relation to financial statements.
- Carry out audit with professional skepticism
- Exercise professional judgement wherever required.
- Obtain sufficient and appropriate audit evidence.
- Comply with Standards on Auditing.

20.4.1 Ethical Requirements of an Auditor



- **Professional behaviour**- Professional relation should be maintained between client and auditor throughout the audit and other interest should override this objective.
- **Objectivity** –Auditor should be independent not just outwardly, but also inwardly. Also, auditor should be focused on the purpose of audit and discharge his duty effectively.
- **Professional competence and due care** – This indicate thorough professional knowledge and its dynamic updation, coupled with its meticulous application.
- **Confidentiality**- Not to part with information obtained by him regarding client during the course of audit with any person other than
  - The client
  - A person authorized by the client
  - A person who legally is entitled to know this information
- **Integrity** – Honest and loyal behaviour of auditor towards users of financials. This gets strengthened with high degree of independence.

20.4.2 Professional Skepticism

- Professional skepticism is necessary to the critical assessment of audit evidence, includes being alert to

> Professional skepticism is an attitude of auditor which requires auditor's alertness towards information provided to him by the client / auditee.

ascertain sufficiency and appropriateness of audit evidence, for example, auditor needs to be :

- Audit evidence that contradicts other audit evidence obtained.
- Information about the reliability of documents and responses to inquiries to be used as audit evidence.

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- Conditions that may indicate possible fraud.
- Circumstances that suggest the need for audit procedures in addition to those required by the SAs.

Benefits of following professional skepticism – **Minimize the risk** of overlooking

- Unusual circumstances
- Using inappropriate assumptions

- Professional skepticism doesn't mean that auditor doubts every bit of information given by the client. Auditor may accept records provided to him as genuine unless he has a reason to believe the contrary. However, he should bear in mind that there is a possibility of its misstatement and follow a cautious approach.

Auditor should not doubt everything but always be alert that there is a possibility of misstatement.

20.4.3 Professional Judgement

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Professional judgement is judgement taken by auditor out of his professional experience in an audit situation

- Professional Judgment is necessary for audit procedures in aspects like
  - Materiality and audit risk.
  - The nature, timing, and extent of audit procedures used to meet the requirements of the SAs and gather audit evidence.
  - Evaluating whether sufficient appropriate audit evidence has been obtained, and whether more needs to be done to achieve the objectives of the SAs and thereby, the overall objectives of the auditor.
  - The evaluation of management's judgments in applying the entity's applicable financial reporting framework.
  - The drawing of conclusions based on the audit evidence obtained, for example, assessing the reasonableness of the estimates made by management **in** preparing the financial statements.

Auditor's professional judgement should be rational, reasonable and appropriate to the circumstances.

Professional Skepticism vs Professional Judgement

Professional skepticism is necessary for high-quality professional judgment, but it is only one component of what is necessary for the auditor to exercise sound professional judgment. For example, skepticism without requisite accounting and auditing industry expertise is not sufficient to obtain high-quality judgment.

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20.4.4 Sufficient & Appropriate Audit Evidence

Audit evidence is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit.

Sufficient Audit Evidence = Quantity of evidence.
(Eg. Testing the 70% of the transactions.)
Appropriate Audit Evidence = Quality of evidence. (relevance & reliability in supporting auditor's conclusion)
(Eg. Obtaining 3rd Party confirmations.)

In Audit both quality and quantity are equally important. This concept is elaborated in SA 500.

20.4.5 Compliance with SAs

The auditor shall comply with all SAs relevant to the audit. SA is relevant to the audit when the SA is in effect and the circumstances addressed by the SA exist. The auditor shall have an understanding of the entire text of a SA, including its application and other explanatory material, to understand its objectives and to apply its requirements properly

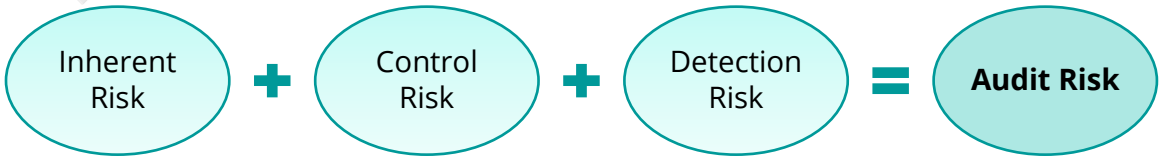
The auditor shall not represent compliance with SAs in the auditor's report unless the auditor has complied with the requirements of this SA and all other SAs relevant to the audit.

20.5 Audit Risk

Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated.

20.5.1 Components of Audit risk

Audit risk is a function of the risks of material misstatement (i.e. Inherent Risk + Control Risk) and detection risk.
Material misstatement is a combination of Inherent Risk and Control Risk



- **Inherent Risk**
  The susceptibility of an assertion about a class of transaction, account balance or disclosure to a **misstatement that could be material**, either **individually or when aggregated** with other misstatements, before consideration of any related controls.
- **Control risk**

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The risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material; either individually or when aggregated with other misstatements, **will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.**

- **Detection risk**
  The risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will **not detect a misstatement that exists** and that could be material, either individually or when aggregated with other misstatements.

Control Risk is inversely related to Detection Risk.

If the internal controls of an organization are effective it means the control risk is low and auditor will perform lesser audit procedures which results in higher detection risk and vice versa.

Auditor has to plan his procedures to minimize the audit risk after taking into consideration the three risks.

20.5.2 Risk of Material Misstatement

Misstatement – A difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework

Risk of material misstatement exists at two levels.

Overall financial statement level
The overall financial statement level (risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions) and

Assertion level
The assertion level for classes of transactions, account balances, and disclosures.

SA 315 establishes requirements and provides guidance on identifying and assessing the risks of material misstatement at the financial statement and assertion levels.

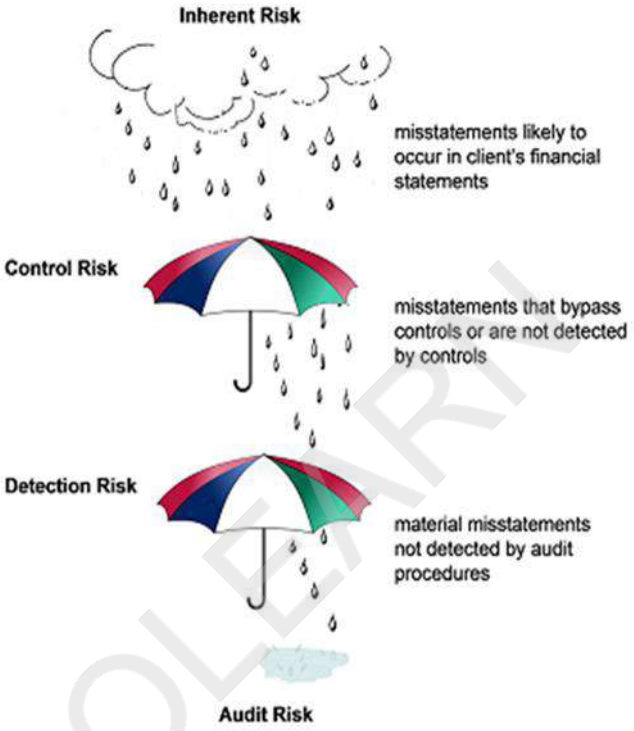
Misstatements can arise from error or fraud.

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20.5.3 Audit risk & Audit plan

Auditor has to plan his procedures to minimize the audit risk after taking into consideration the three risks.

Example: The inherent risk is that it's raining, which is controlled by the nature and has no bearing of the audit. This is compared to the risk that misstatements are likely to occur in Financial Statements. Like how an umbrella can help us from not getting wet, controls of company are designed to avoid misstatements. The risk that we might get wet even after using an umbrella is control risk. Next is the detection risk, where we did not anticipate the rainfall or the size of the umbrella is smaller than required is compared to audit procedures to apply during the audit. All the three risks together make Audit risk.



20.6 Objective Stated in Individual SAs

To achieve the overall objectives of the auditor, the auditor shall use the objectives stated in relevant SAs in planning and performing the audit, having regard to the interrelationships among the SAs, to

- Determine whether any audit procedures in addition to those required by the SAs are necessary in pursuance of the objectives stated in the SAs; and
- Evaluate whether sufficient appropriate audit evidence has been obtained.

20.6.1 Failure to achieve an objective

If an objective in a relevant SA cannot be achieved, the auditor shall evaluate whether this prevents the auditor from achieving the overall objectives of the auditor and thereby requires the auditor, in accordance with the SAs, to modify the auditor's opinion or withdraw from the engagement.

Failure to achieve an objective represents a significant matter requiring documentation in accordance with SA 230 (Revised).

20.7 Complying with Relevant Requirements

If the standard is applicable, it shall be complied with.

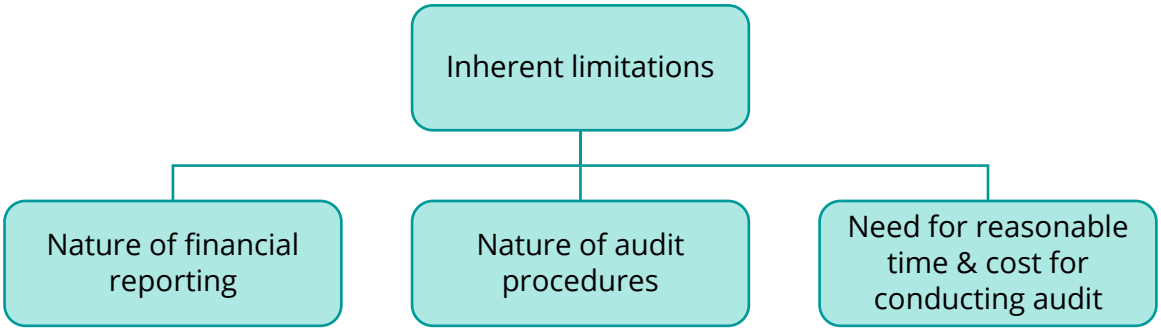
In exceptional circumstances, the auditor may judge it necessary to depart from a relevant requirement in a SA. In such circumstances, the auditor shall perform alternative audit procedures to achieve the aim of that requirement.

The need for the auditor to depart from a relevant requirement is expected to arise only where the requirement is for a specific procedure to be performed and, in the specific circumstances of the audit, that procedure would be ineffective in achieving the aim of the requirement.

20.8 Inherent Limitations of the Audit

The inherent limitations of an audit do not allow an auditor to reduce the audit risk to zero. It is because of these limitations; the auditor gives a persuasive opinion and not a conclusive opinion.

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- **Nature of financial reporting**
  - Preparation financials also involves certain estimates, assumptions, assessments and acceptable interpretations.
  - In such cases, inherent level of variability cannot be eliminated by the application of additional auditing procedures.
- **Nature of audit procedures**
  - Management or others may not provide, intentionally or unintentionally, the complete information that is relevant to the preparation and presentation of the financial statements.
  - Certain carefully laid frauds might not be unearthed during the normal course of audit.
  - Generally, test check basis is adopted, not 100% checking. So, some underlying misstatement might remain undetected.
  - Audit is persuasive, not conclusive.
  - Limitations on knowledge of client's business also poses a problem.
- Need for the audit to be conducted within a **reasonable period of time** and at a reasonable cost.

20.8.1 Factors affecting inherent limitations

Factors affecting inherent limitations are addressed in other auditing standards. Following are few of the factors:

- Fraud, particularly fraud involving senior management or collusion.
- The existence and completeness of related party relationships and transactions.
- The occurrence of non-compliance with laws and regulations.
- Future events or conditions that may cause an entity to cease to continue as a going concern.

20.8.2 Inherent limitations and Auditors' responsibility

Because of the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with SAs.

Accordingly, the subsequent discovery of a material misstatement of the financial statements resulting from fraud or error does not by itself indicate a failure to conduct an audit in accordance with SAs.

Whether the auditor has performed an audit in accordance with SAs is determined by the audit procedures performed in the circumstances, the sufficiency and appropriateness of the audit evidence obtained as a result thereof and the suitability of the auditor's report based on an evaluation of that evidence in light of the overall objectives of the auditor.



The inherent limitations of an audit cannot be a justification for the auditor to be satisfied with less-than-persuasive audit evidence

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AUDIT STRATEGY, AUDIT PLANNING AND AUDIT PROGRAMME

Contents

- Audit Planning and its benefits
- Planning process and its elements
- Audit Strategy and Audit Plan
- Audit Programme
- Control of quality of audit work

1. Audit Strategy and Planning

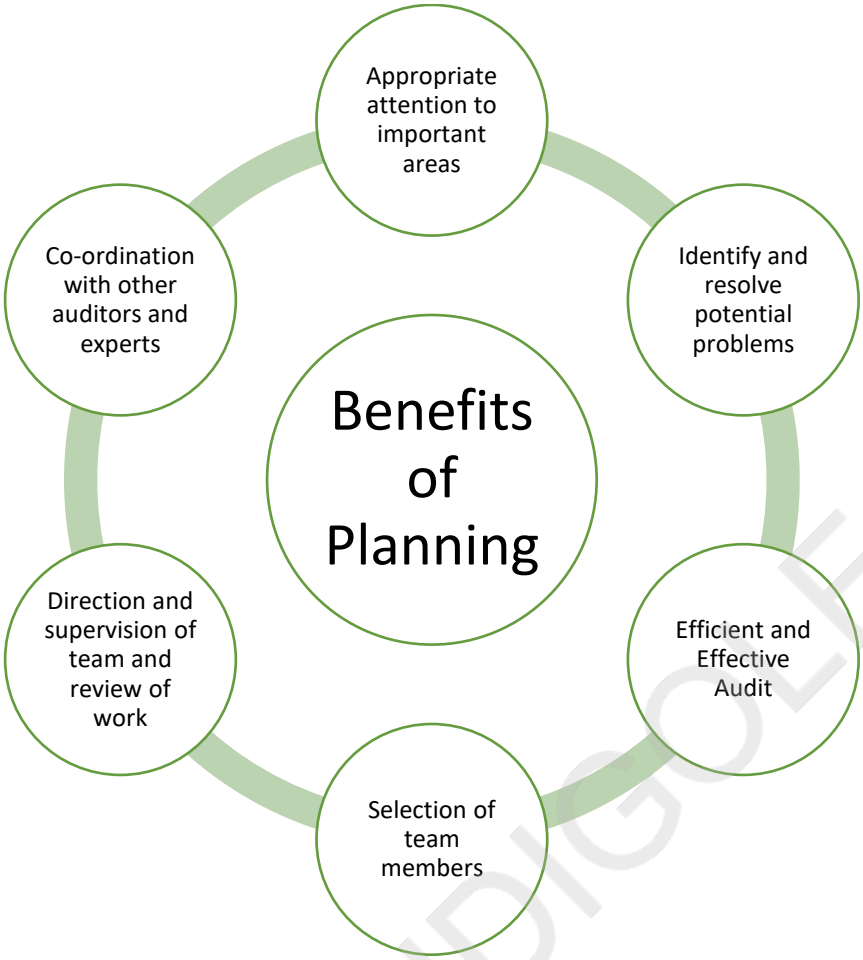
1.1 Audit Planning

- It is said, 'Well begun is half done'. Thus, audit planning is the ***preparatory work done by the auditor before he starts the audit***. It is an essential step in conducting the audit. Audit flow chart is given below
- SA-300, "Planning an Audit of Financial Statements" further emphasizes that planning is not a discrete phase of an audit, but rather a ***continual and iterative process.*** Plans should be further developed and revised as necessary during the course of the audit.
- Per SA- 300 the process begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement.
- ***The auditor shall establish an overall audit strategy*** that sets the scope, timing, and direction of the audit, and that guides the development of the audit plan.

1.2 Benefits of Audit Planning

1. Helping the auditor to devote appropriate attention to important areas of the audit.
2. Helping the auditor identify and resolve potential problems on a timely basis.
3. Helping the auditor properly organize and manage the audit engagement so that it is performed in an effective and efficient manner.
4. Assisting in the selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks, and the proper assignment of work to them.
5. Facilitating the direction and supervision of engagement team members and the review of their work.
6. Assisting, where applicable, in coordination of work done by others such as experts

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2. Nature of Audit Planning- A Continuous and iterative process

i. Planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement.

ii. Planning, however, includes consideration of the timing of certain activities and audit procedures that need to be completed prior to the performance of further audit procedures. For example, *planning includes the need to consider, prior to the auditor's identification and assessment of the risks of material misstatement, such matters as: -*

a. The analytical procedures to be applied as risk assessment procedures.
b. Obtaining a general understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework.
c. The determination of materiality.
d. The involvement of experts.
e. The performance of other risk assessment procedures.

Planning includes

Involvement of key engagement team members in planning audit

The engagement partner and other key members of the engagement team shall be involved in planning the audit including planning and participating in the discussion among engagement team members.

Discussion of elements of planning with entity's management

The auditor may decide to discuss elements of planning with the entity's management to facilitate the conduct and management of the audit engagement. When discussing matters included in the overall audit strategy or audit plan, care is required in order not to compromise the effectiveness of the audit.

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Planning Process- Elements of Planning



(I) Preliminary engagement activities

The auditor considers whether relationship with client should be continued and whether ethical requirements including independence continue to be complied with. It includes: -

- Performing procedures regarding the continuance of the client relationship (SA 220)
- Evaluating compliance with ethical requirements, including independence (SA 220)
- Establishing an understanding of terms of engagement (SA 210)

Performing procedures regarding the continuance of the client relationship (SA 220)

a) Ensure that appropriate procedures regarding the acceptance and continuance of client relationships and audit engagements have been followed and that conclusions reached in this regard are appropriate.
b) Obtain information considered necessary in the circumstances
   - before accepting an engagement with a new client,
   - when deciding whether to continue an existing engagement, and
   - when considering acceptance of a new engagement with an existing client.
c) Matters such as integrity of principal owners and key management, competence of engagement team to perform the audit engagement and implications of matters that have arisen during current and previous audit engagement may need to be considered.

Evaluating compliance with ethical requirements, including independence (SA 220)

The auditor shall continuously evaluate compliance with ethical requirements including independence.
The engagement partner shall remain alert, through observation and making inquiries as necessary, for evidence of non-compliance with relevant ethical requirements by members of the engagement team.
The engagement partner shall form a conclusion on compliance with independence requirements that apply to the audit engagement. In doing so, the engagement partner shall: -

i. Obtain relevant information from the firm to identify and evaluate circumstances and relationships that create threats to independence
ii. Evaluate information on identified breaches, if any, of the firm's independence policies and procedures to determine whether they create a threat to independence for the audit engagement and
iii. Take appropriate action to eliminate such threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the audit engagement, where withdrawal is permitted by law or regulation.
iv. The engagement partner shall promptly report to the firm any inability to resolve the matter for appropriate action.

Establishing an understanding of terms of engagement (SA 210)

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It is in the interests of both the entity and the auditor that the auditor sends an audit engagement letter before the commencement of the audit to help avoid misunderstandings with respect to the audit. It ensures that there is no confusion with the client regarding terms of the engagement

(II) Planning activities

Planning activities involve: -

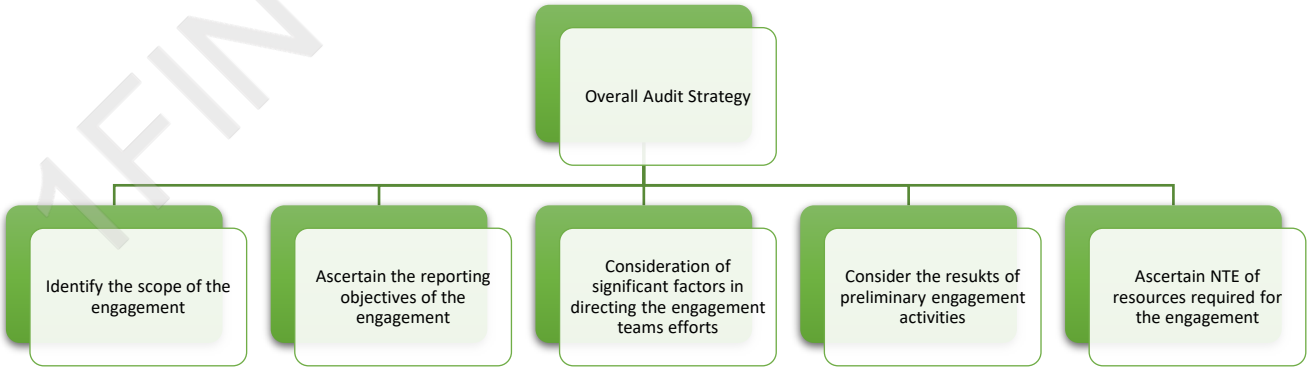
- Establishing the overall audit strategy
- Developing an audit plan

Overall Audit Strategy

- The overall audit strategy and the audit plan remains the auditor's responsibility. By no means it can, be shared with the management. However, to coordinate some of the planned audit procedures with the work of the entity's personnel such discussions are necessary.
- When discussing matters included in the overall audit strategy or audit plan, care is required in order not to compromise the effectiveness of the audit. The involvement of the engagement partner and other key members of the engagement team in planning the audit enhances the effectiveness and efficiency of the planning process. It is because of their experience, expertise and insights.
- **The process of establishing the overall audit strategy assists the auditor to determine**:

a) The resources to deploy for specific audit areas - such as
b) The use of appropriately experienced team members for high risk areas.
c) The involvement of experts on complex matters etc.
d) The number of resources to allocate to specific audit areas - such as
e) The number of team members assigned to observe the inventory count.
f) The extent of review of other auditors' work in the case of group audits.
g) Time of resources deployment -Example
h) Whether at an interim audit stage or at key cut-off dates.
i) How many days for internal control testing etc.
j) How such resources are managed, directed, and supervised - Example
k) When team briefing and debriefing meetings are expected to be held
l) How engagement partner and manager reviews are expected to take place (for example, on-site or off-site).

In establishing the overall audit strategy, the auditor shall



Identify the characteristics of the engagement that define its scope

- Number and locations or branches to be audited.
- Nature of business (E.g.: Manufacturing, service oriented etc) and number of business segments.
- Applicable FRF
- Expected use of audit evidence obtained in previous audit

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- Industry specific reporting requirements by industry regulators
- Previous experience gained about the client etc.

Ascertain the reporting objectives of the engagement to plan the timing and the nature of the communications required -

- The entity's timetable for reporting
- Organization of meetings to discuss of nature, timing and extent of audit work with management
- Discussion with management regarding the expected type and
- timing of reports to be issued including the auditor's report
- Discussion with management regarding the expected communications on the status of audit work throughout the engagement.
- Expected nature and timing of communications among engagement team members, including the nature and timing of team meetings and timing of the review of work performed

Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts –

The auditor needs to direct efforts of engagement team towards matters that in his professional judgment are significant. Preliminary identification of material classes of transactions, account balances and disclosures help auditor in establishing overall audit strategy. More energies need to be devoted to significant matters to obtain desired outcomes. Few examples are listed as under: -

- Volume of transactions which may determine whether it is more efficient for the auditor to rely on internal control
- Significant industry developments such as changes in industry regulations and new reporting requirements.
- Significant changes in the financial reporting framework, such as changes in accounting standards.
- Other significant relevant developments, such as changes in the legal environment affecting the entity

Consider the results of preliminary engagement activities –

Considering results of preliminary engagement activities and knowledge gained from similar engagements goes a long way in establishing sound audit strategy. Examples are listed as under: -

- Results of previous audits that involved evaluating the operating effectiveness of internal control, including the nature of identified deficiencies and action taken to address them.
- The manner in which the auditor emphasizes to engagement team members the need to maintain a questioning mind and to exercise professional skepticism in gathering and evaluating audit evidence**.**

Ascertain the nature, timing, and extent of resources necessary to perform the engagement.

- Selection of engagement team and assignment of audit work to team members is a significant factor in establishing overall audit strategy. Experienced team members may be assigned in areas where there is higher risk of material misstatement.

Development of Audit plan

Once the overall audit strategy has been established, an audit plan can be developed to address the various matters identified in the overall audit strategy, taking into account the need to achieve the audit objectives through the efficient use of the auditor's resources.

Understanding client's business is one of the important principles in developing an audit plan. In fact, without adequate knowledge of client's business, a proper audit is not possible.

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SA-300 states that auditor shall develop an audit plan that shall include description of-

- The nature, timing and extent of planned risk assessment procedures
- The nature, timing and extent of planned further audit procedures at assertion level
- Other planned audit procedures that are required to be carried out so that the engagement complies with SAs.

3. Audit Strategy vs. Audit Plan

- In very simple terms, strategy refers to Where one wants to reach, and planning refers to how to reach there.
- Thus, the audit planning is based on the strategic goals of the audit firm.
- Audit strategy sets the broad overall approach to the audit whereas audit plan addresses the various matters identified in the overall audit strategy.

- **Audit strategy**
  Sets the scope, timing, and direction of the audit.
- **Audit planning**
  It is the procedure to execute/achieve the

- Audit strategy determines scope, timing and direction of audit. Audit plan describes how strategy is going to be implemented. The audit plan is more detailed than the overall audit strategy that includes the nature, timing and extent of audit procedures to be performed by engagement team members. Planning for these audit procedures takes place over the course of the audit as the audit plan for the engagement develops.
- Once the overall audit strategy has been established, an audit plan can be developed to address the various matters identified in the audit strategy
- The audit strategy and the detailed audit plan are closely inter-related since changes in one may result in consequential changes to the other.

Establishment of Overall Audit Strategy and audit plan- Auditors responsibility

The overall audit strategy and the audit plan remains the ***auditor's responsibility.*** By no means it can, be shared with the management. However, ***to coordinate*** some of the planned audit procedures ***with the work of the entity's personnel*** such discussions are necessary.

When discussing matters included in the overall audit strategy or audit plan, care is required in order not to compromise the effectiveness of the audit.

Changes to Planning decision during the course of audit

- The auditor shall update and change the overall audit strategy and the audit plan as necessary during the course of the audit.

- As a result of *unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures,* the auditor may need to modify the overall audit strategy and audit plan and thereby the resulting planned nature, timing and extent of further audit procedures, based on the revised consideration of assessed risks.

- This may be the case when information comes to the auditor's attention that differs significantly from the information available when the auditor planned the audit procedures.

- For example, audit evidence obtained through on detailed checking may contradict the audit evidence obtained through testing internal controls.

Planning the direction, supervision and review of Work of Engagement team members

- Direction refers to giving guidance to the audit team by the engagement partner. The guidance is given both while framing the audit plan and also while executing it.

- Supervision and review refer to the constant overview of the plans by the superiors and engagement partner.

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- It provides a constant feedback and support mechanism to ensure the achievement of audit goals.
- Thus, the auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work.
- The factors that influence the nature, timing and extent of direction, supervision and review are:
    - The size of the audit entity.
    - The complexity of the audit entity.
    - The area of the audit
    - The assessed risks of material misstatement
    - The capabilities and competence of the individual team members performing the audit work.

Documentation

The following should be documented:

- The overall audit strategy – It is a record of
    i. Key decisions considered necessary to properly plan the audit and
    ii. Communicate significant matters to the engagement team.
- The audit plan – It is a record of
    i. The planned nature, timing, and extent of risk assessment procedures and
    ii. Further audit procedures at the assertion level in response to the assessed risks.
- Any significant changes made during the audit engagement to the overall audit strategy or the audit plan and the reasons for such changes – It is a record which explains
    i. Why the significant changes were made,
    ii. The overall strategy and audit plan finally adopted for the audit and
    iii. The appropriate response to the significant changes occurring during the audit.

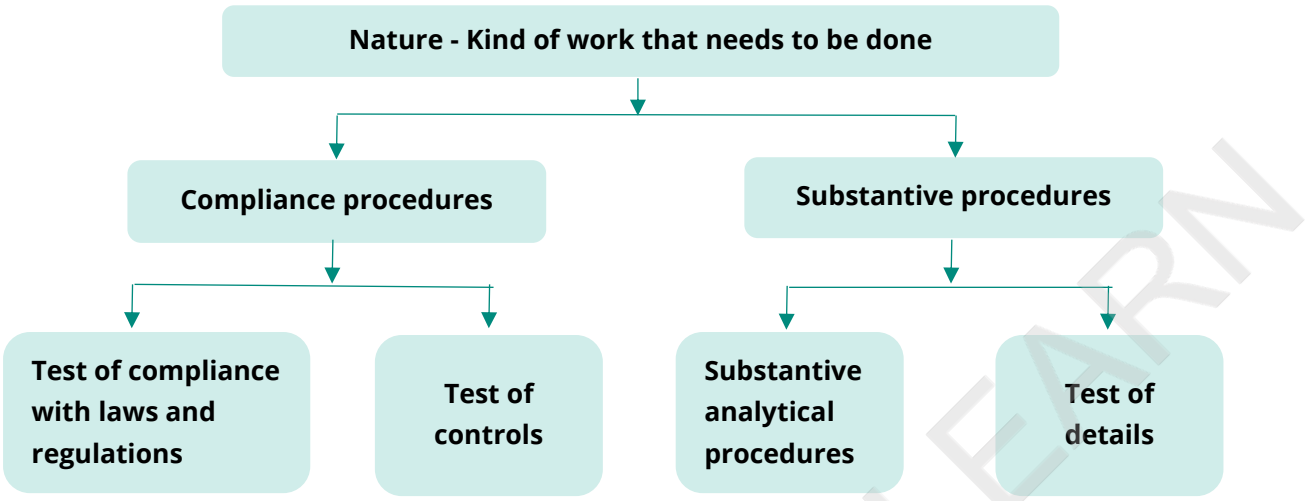
Additional notes on Conceptual understanding

4. Nature, Timing and Extent of Audit Planning

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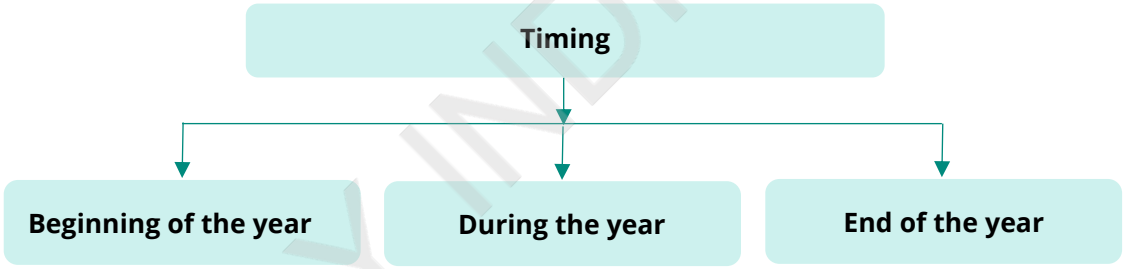
4.1 Nature

Refers to kind of work that needs to be done.



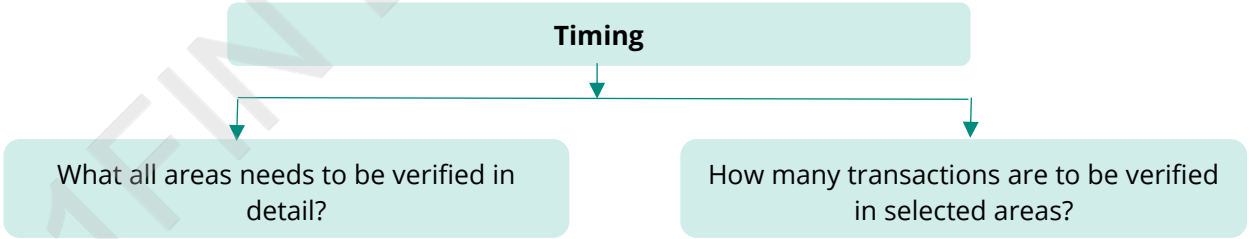
4.2 Timing of audit procedures

Refers to time when the audit procedures have to be performed. For e.g.: If the auditor wants to verify the cash balance as on 31st March, then physical verification has to happen on that day itself.



4.3 Extent

Refers to the scope of work to be included.



One of the important principles in developing an overall audit plan is Knowledge of the Client's Business. In fact, without adequate knowledge of client's business, a proper audit is not possible. What should the auditor know as part of knowledge of client's business? Explain with examples.

Yes. Knowledge of client's business is the ***primary requirement*** for audit planning. As each business has its own risk. Only a complete knowledge of client's business will ***help him in performing risk assessment procedures***.

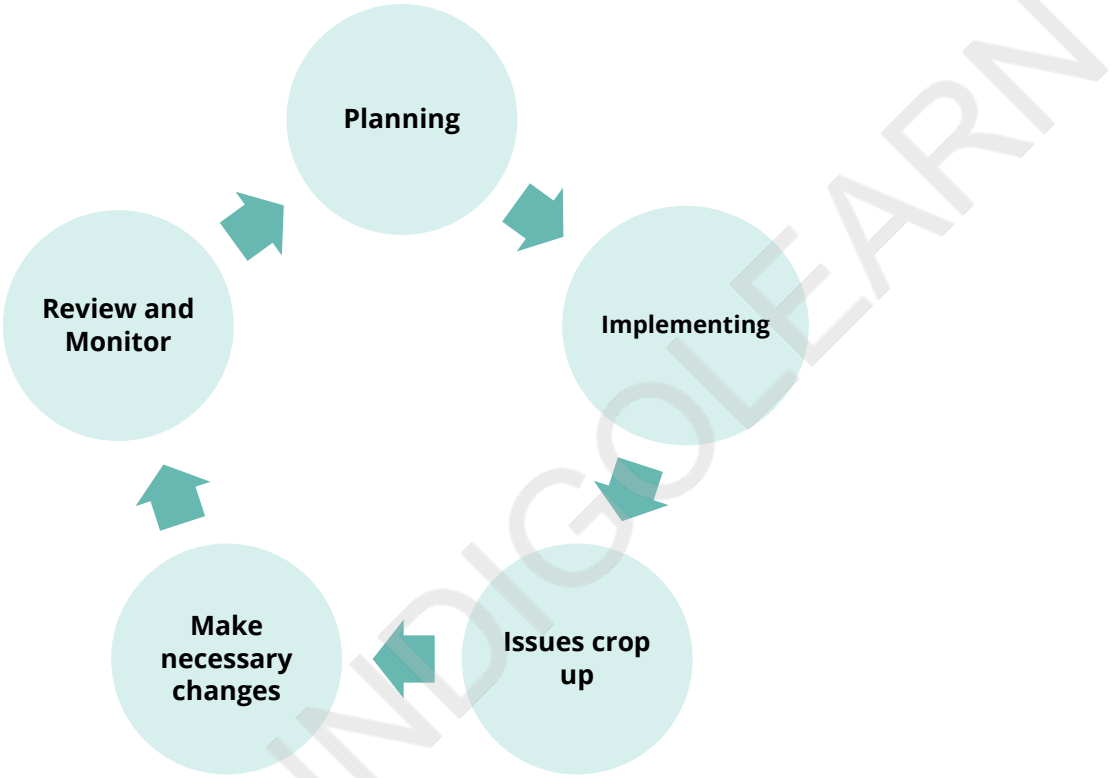
Additional Considerations

- The auditor shall undertake the following activities prior to starting an initial audit:

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- Performing procedures required by SA 220 regarding the acceptance of the client relationship and specific audit engagement, and
- Communicating with the predecessor auditor, where there has been a change of auditors, in compliance with relevant ethical requirements

Planning- A Continous Process



Audit Programme

Audit programme, Audit plan and Audit strategy

An audit programme is a detailed plan of applying the audit procedures in the given circumstances with instructions for the appropriate techniques to be adopted for accomplishing the audit objectives.

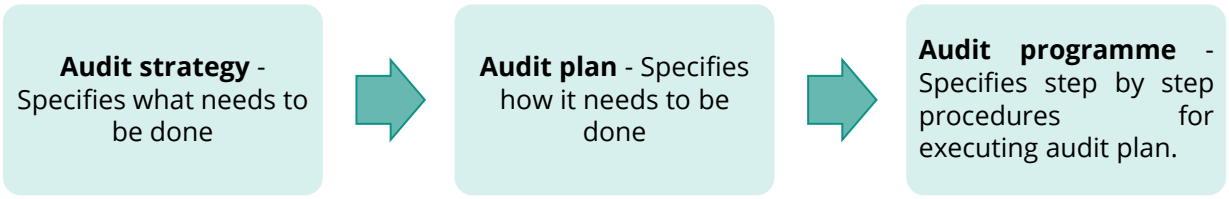
It is a ***list of examination and verification steps*** to be applied and set out in such a way that the inter-relationship of one step to another is clearly shown.

Detailed plan of applying the audit ***procedures*** → With instructions for the appropriate ***techniques*** to be adopted → for accomplishing the audit ***objectives***.

Audit programme is nothing but an elaborate description of steps to execute audit plan. Thus, it ensures the accomplishment of audit plan. And Audit plan ensures the accomplishment of audit strategy.

The relationship between audit plan, strategy and programme can be shown as below.

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4.4 Features of an Audit programme

The following are the features of an audit programme:

5.2.1 One Audit Programme for every audit

The following factors vary from assignment to assignment.

- Nature of business, their size and composition
- Work which is suitable to one business may not be suitable to others,
- Efficiency and operation of internal controls and
- The exact nature of the service to be rendered by the auditor.

Thus, one audit programme applicable to all business under all circumstances is not practicable. We need to draw a separate audit programme for every engagement.

5.2.2 The Assistant engaged – Be encouraged to keep an open mind

The engagement team should be instructed to

- ***Trust the audit programme***
  - The trust can be built by involving them in the planning phase itself.
- ***Keep an open mind and focused view***
  - Open mind refers to being vigilant and make necessary changes to the programme wherever required and
  - Focused view refers to ensuring that the procedure followed helps to meet the objective.
- ***Note and report significant matters*** coming to his notice, to his seniors or to the engagement partners.

So long as the suggested change is not approved by the principal, every team member should stick to the initial programme. This is only to ensure that only genuine changes are made.

Periodic Review of The Audit Programme

The auditor prepares a standard audit programme keeping in mind the

- nature, size, and composition of the business
- the dependability of the internal control
- His past experience with such engagement
- and the given scope of work.

However periodic review of the audit programme should be done to assess

- If there are any inadequacies in collecting the proper evidence.
- If there is any procedure which is redundant and need not be carried on.
- If it is relevant to the audit, based on the changed facts and circumstances.

The client's operations and internal control should also be reviewed periodically.
If periodic review is not done -

- any change in the business policy of the client may not be adequately known.
- the auditor may have to face legal consequences for negligence of duty.

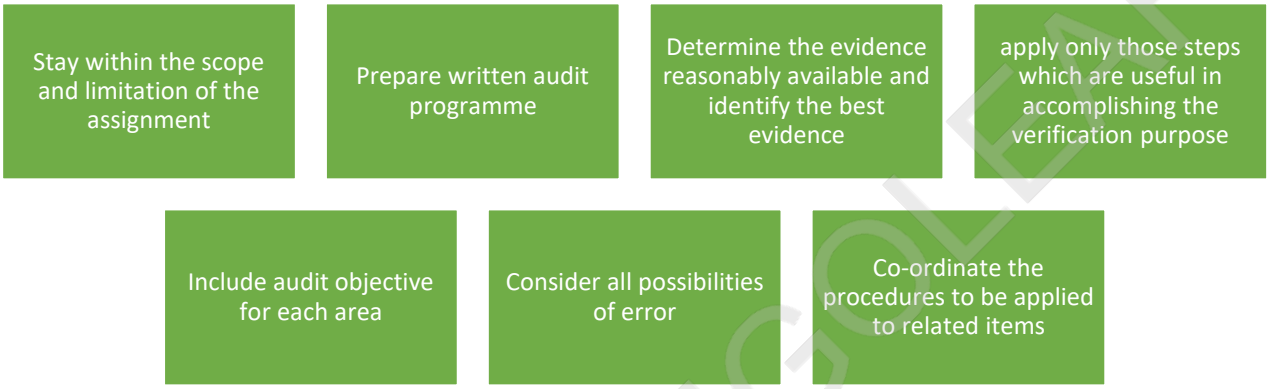
Important points for constructing an Audit programme

The following are the key factors to be kept in mind while drawing an audit programme:

i. **Stay within the *scope and limitation* of the assignment**.

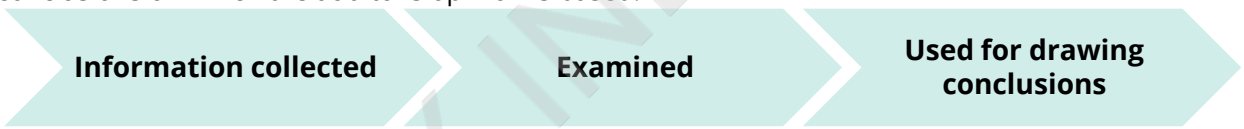
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ii. **Determine the evidence reasonably available and identify the *best evidence for deriving the necessary satisfaction.***
iii. **Prepare written audit programme setting forth the procedure that are needed to implement the audit plan**
iv. **Apply only those steps and *procedures which are useful* in accomplishing the verification purpose in the specific situation.**
v. **Consider all *possibilities of error.***
vi. ***Co-ordinate the procedures* to be applied to related items.**
vii. **Include the audit objectives for each area and sufficient details which serve as a set of instructions for the assistants involved in audit and help in controlling the proper execution of the work.**



Audit Programme is designed to provide Audit Evidence

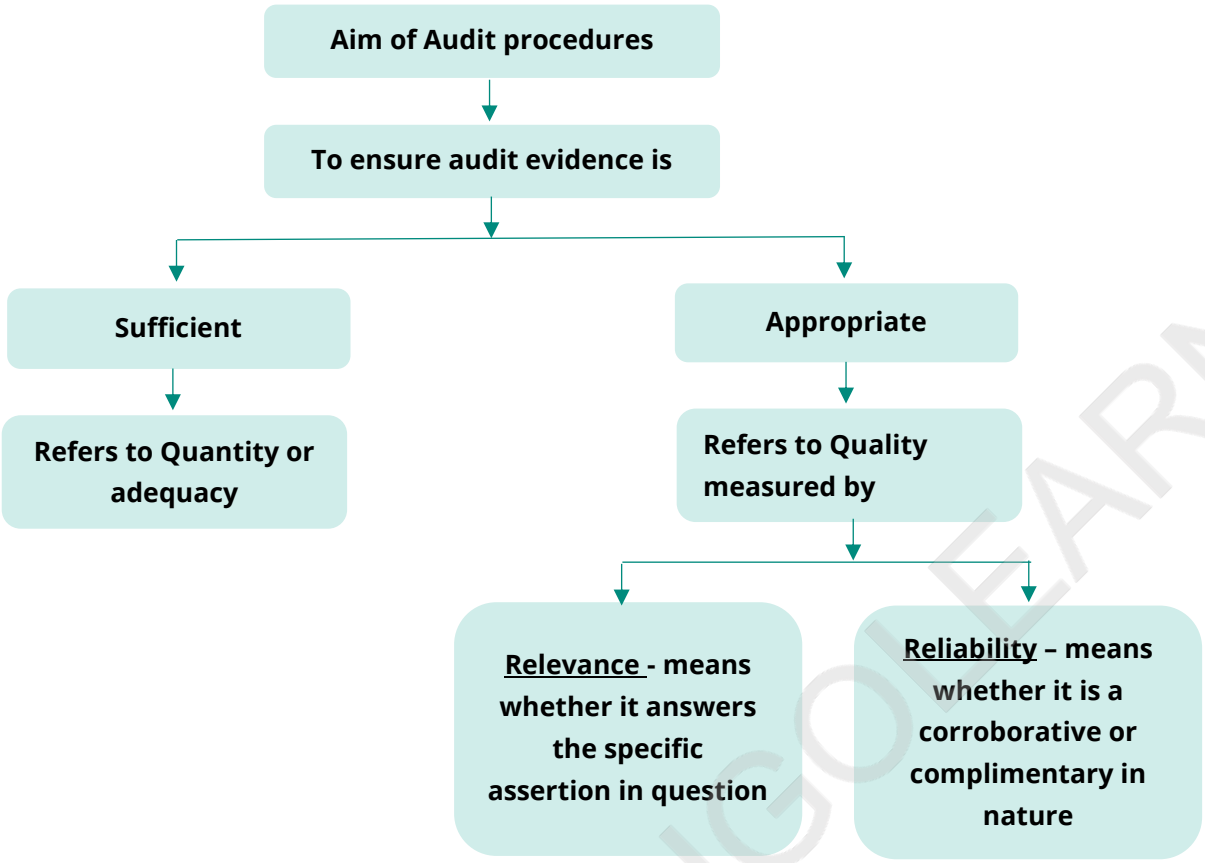
Audit Evidence is defined as the information collected, examined, and used by the auditor in arriving at the conclusions on which the auditor's opinion is based.



It can be either from an ***internal source or from an external source***.
As per the audit flowchart (discussed in chapter 1), audit techniques are applied to obtain audit evidence.

And audit procedures are performed to examine the audit evidence. In other words, audit procedures are aimed at ensuring the sufficiency and appropriateness of the audit evidence. So that appropriate opinion can be formed.

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What is ***best evidence is a matter of expert knowledge and experience***. This is the primary task before the auditor when he draws up the audit programme.
In all cases ***one procedure may not bring the highest satisfaction*** and thus he has to collect many evidences for the same assertion.
Each evidence is weighed to ascertain its weight to prove or disprove the assertion.

Advantages & Disadvantages of audit programme

Advantages

- Provides ***clear set of instructions*** to audit assistants.
- Provides a ***total perspective of the work*** to be performed.
- Helps in ***Selection of audit team*** on the basis of capabilities.
- Ensures that ***all areas and issues relevant to audit are considered***.
- Ensures ***accountability of audit assistants***.
- Principal can ***control the progress of the various audits*** in hand.
- Serves as a ***guide for audits to be carried out in the succeeding year.***
- Serves as ***evidence in the event of any charge*** of negligence being brought against the auditor.

Disadvantages

- ***Incomplete audit programmes*** may increase the risk of material misstatement.
- ***Inefficient assistants may take shelter*** behind the programme
- Hard and fast audit programme may ***kill the initiative of efficient and enterprising assistants.***

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Disadvantages may be eliminated by

- ***Extensive supervision*** of the work carried on by the assistants.
- The auditor must have a ***receptive attitude*** as regards the assistants and
- The assistants should be encouraged to ***observe matters objectively*** and bring significant matters to the notice of supervisor/principal.

5. Audit Programme - Designed to provide Audit Evidence

Following are few types of audit evidences**:**

- Documentary examination,
- Physical examination,
- Statements and explanation of management, officials and employees,
- Statements and explanations of third parties,
- Arithmetical calculations by the auditor,
- State of internal controls and internal checks,
- Inter-relationship of the various accounting data,
- Subsidiary and memorandum records,
- Minutes,
- Subsequent action by the client and by others.

SA 300 – Planning an Audit of Financial Statements

5.1 Introduction

The objective of auditor is to plan the audit so that it will be performed in an efficient manner.

It helps the auditor obtain sufficient appropriate evidence for the circumstances, helps keep audit costs at a reasonable level, and helps avoid misunderstandings with the client.

Engagement partner and other key members of the audit team shall be involved in planning the audit.

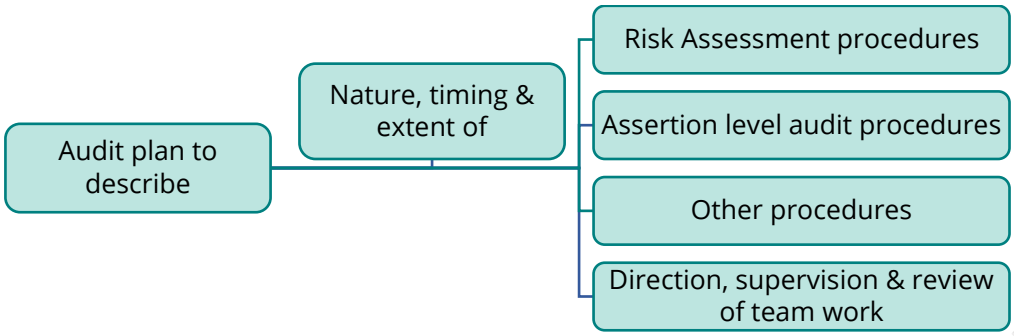
The audit plan is more detailed than the overall audit strategy

Audit plan is a detailed programme giving instructions as to how each area of the audit will be conducted. In other words, the audit plan details the specific procedures to be carried out obtain sufficient appropriate evidence to implement the audit strategy and complete the audit.

5.2 Preliminary Engagement Activities

- Carrying out audit procedures as required by SA 220 "Quality Control for Audit Work "regarding the continuance of the client relationship and the specific audit engagement
- Evaluating compliance with ethical requirements, including independence, as required by SA 220; and
- Establishing an understanding of terms of engagement as required by SA 210, "Terms of Audit Engagement."

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5.3.1 Points considered in audit plan

- What are the deliverables?
- How to achieve the reporting objective?
- The quantum of resources required?
- The time required and the time budget available?
- What procedures and new methods to be involved?
- Review the engagement formalities
- Explain the scope of the engagement to the team.



5.3.2 Benefits of Planning

- To ensure appropriate attention is devoted to important areas of audit;
- Prompt identification and resolution of potential problems;
- Proper organization and management of audit engagement;
- Selection of appropriate engagement team members and proper assignment of work to them.
- To facilitate direction, supervision and review of their work.
- To ensure coordination of work done by other auditors and experts.

5.3.3 Factors to be considered in Planning

- Size and complexity of entity;
- Previous experience of the key engagement team members with the entity;

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- Changes in circumstances during the audit engagement.

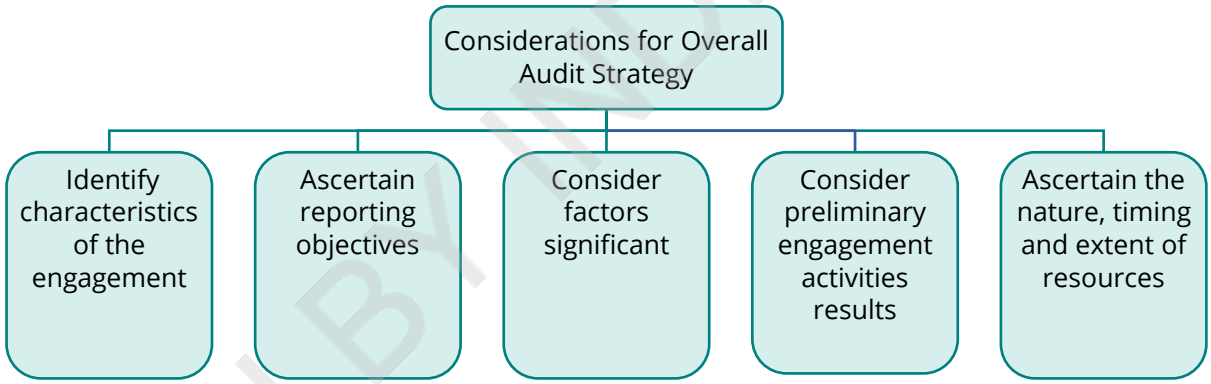
5.4 Critical aspects of Planning

1. Develop Overall Audit Strategy
2. Develop audit plan
3. Update & chagne overall audit strategy & plan
4. Direct, supervise & review of work of engagement team

5.4.1 Overall audit strategy

Auditor has to develop an overall audit strategy that defines the scope, timing and direction of the audit. For that auditor has to:

- Identify the characteristics of engagement.
- Ascertain the reporting objectives.
- Consider factors which are significant to direct the audit team.
- Consider results of preliminary engagement activities and experience from other engagements
- Ascertain the nature, timing and extent of resources necessary to perform the engagement.



5.4.2 Audit Plan

An audit plan should include detailed description of procedures to be performed by engagement team members, which includes

- the nature, timing and extent of risk assessment as per SA 315
- the nature timing extent of planned audit procedures at assertion level as per SA 330
- other planned procedures to ensure compliance with SAs

The auditor has to considering the appropriate amount of time to set aside for areas where there may be higher risks of material misstatement.

Planning the nature, timing and extent of specific further audit procedures depends on the outcome of those risk assessment procedures.

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5.4.3 Updating and improvisation.

Continuous update and change in overall audit strategy and the audit plan desiring the course of audit as a result of unexpected events, changes in conditions or the audit evidence obtained from audit procedures.

This may be the case when information comes to the auditor's attention that differs significantly from the information available when the auditor planned the audit procedures.

5.4.4 Direction, supervision and review

The auditor shall plan the nature, timing and extent Direction, supervision and review of work of engagement team members. This depends on factors like

- Size and complexity of the entity
- Area of audit
- Assessed risks of material misstatements
- Capabilities and competence of the team members

5.5 Documentation

5.5.1 Overall audit strategy

In the form of a memorandum that contains key decisions regarding the

- overall scope,
- timing and
- conduct

of the audit;

5.5.2 Audit plan

In the form of standard audit programs and/or audit completion checklists.

5.5.3 Significant changes

A record of the significant changes to the overall audit strategy and the audit plan, and resulting changes to the planned nature, timing and extent of audit procedures, explains why the significant changes were made, and the overall strategy and audit plan finally adopted for the audit.

5.6 Additional Considerations in Initial Audit Engagements

1. Name of client: Lanco Infra tech Ltd.
2. Nature of assignment: Statutory Audit
3. Period of audit: F.Y ended 31/03/2017
4. Start date: 01/04/2017
   End date: 30/04/2017
5. Audit Team: A, B, C, D, E
6. Audit Partner: XYZ

7. TASKS

Area	Allotted person	Start Date	End Date	Management co-ordinater	Review
Fixed assets	A	02/04/17	06/04/17	L	X
Debtors	B	01/04/17	15/04/17	M	Y
Investments	C	04/04/17	09/04/17	N	Z
Bank OD	D	03/04/17	10/04/17	O	Y
Creditors	E	01/04/17	08/04/17	P	Z

Remarks

- Perform procedures required by SA 220 regarding the accepting of client relationship;
- Communicate with predecessor audit, where there has been a change of auditors.
- Checking opening balances

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5.7 Questions

1) The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on knowledge of the client's business. Explain. [RTP-Nov. 18]
2) Plans should be made to cover acquiring knowledge of the client's accounting systems, policies and internal control procedures. Explain. [RTP-Nov. 19]
3) Comment on the following in relation to SAs: Auditor shall establish an overall strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan". [May 11 (5 Marks)]
4) In establishing overall audit strategy, the auditor shall ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required. Elucidate those cases by which auditor can ascertain the reporting objectives of the engagement. [Nov. 19 (4 Marks)]
5) State correct or not "Planning is not a discrete phase of an audit, but rather a continual and iterative process. [RTP-May 19]
6) "The Nature, timing and extent of the direction and supervision of engagement team members and review of their work vary depending on any factors." Explain

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SA 230 – Audit Documentation

Contents

- Nature & Purpose of Audit documentation
- Form, Content & Extent of Audit documentation
- Time limit, ownership and retention of working papers
- Permanent and Current Audit Files

Introduction

The auditor shall prepare audit documentation of the audit procedures performed and audit evidence obtained on a timely basis.

Audit documentation – The record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached (terms such as "working papers" or "workpapers" are also sometimes used).

Documentation is synonymous with working papers. Audit working papers constitute all documents

- prepared
- obtained
- retained

by the auditor during the course of audit and the audit conclusions.

Audit done but not documented is audit not done

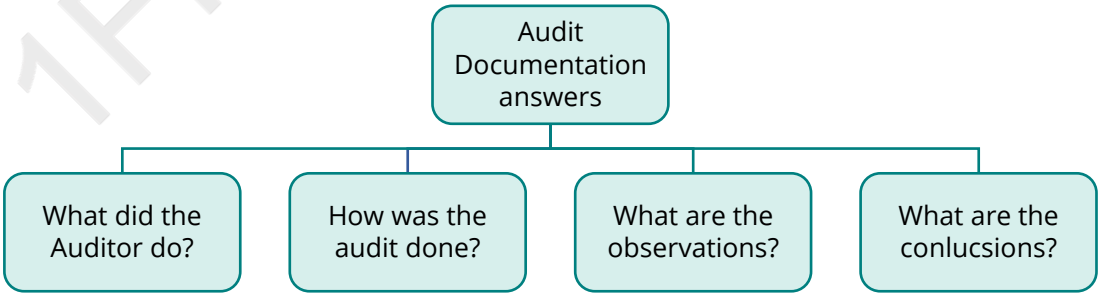
Audit file contains the records (physical or electronic form) that comprise the audit documentation for a specific engagement.

1.1 Nature & Purpose of Audit Documentation

Audit documentation mainly serves as an evidence:

(a) Evidence of the auditor's basis for audit report; and

(b) Evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.



1.1.1 Additional Purposes

- Assisting the engagement team to plan and perform the audit.
- Assisting members of the engagement team responsible for supervision to direct and

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supervise the audit work.

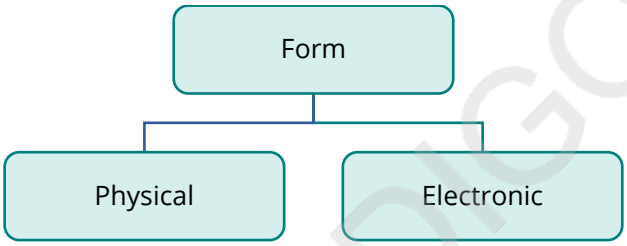
- Enabling the engagement team to be accountable for its work.
- Retaining a record of matters of continuing significance to future audits.
- Enabling the conduct of quality control reviews and inspections.
- Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

1.2 Form, Content & Extent

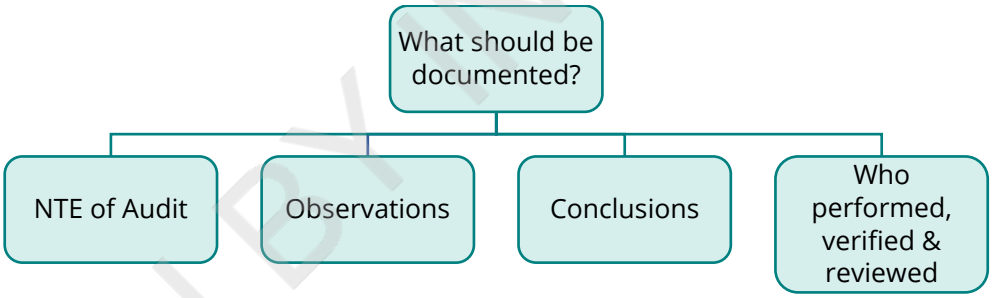
The form, content and extent of audit documentation depend on factors such as:

- size and complexity of the entity.
- nature of the audit procedures to be performed.
- identified risks of material misstatement.
- significance of the audit evidence obtained.
- nature and extent of exceptions identified.
- need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained.
- audit methodology and tools used.

1.2.1 Form



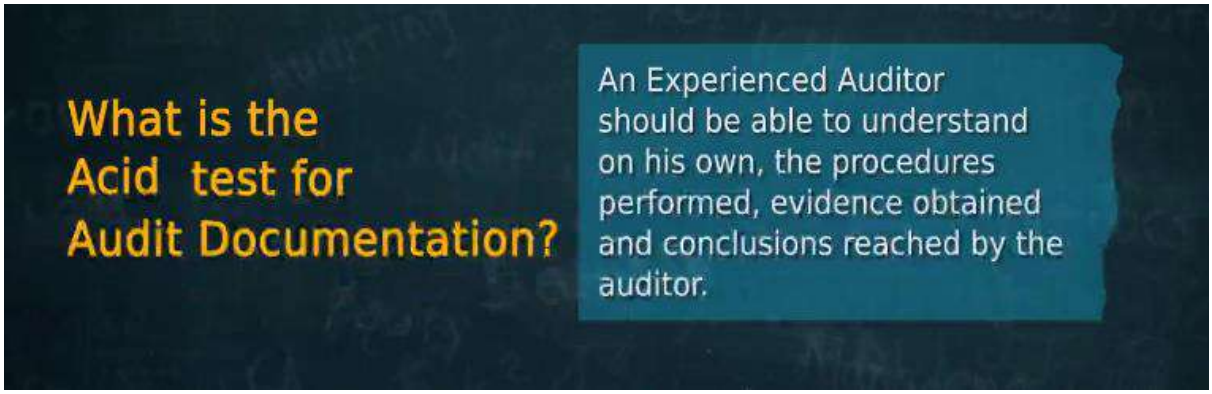
1.2.2 Content



The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor to understand:

- The nature, timing, and extent of the audit procedures; (NTE)
- The results / observations of the audit procedures performed, and the audit evidence obtained; and
- Significant matters arising during the audit and the conclusions reached thereon.

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Experienced Auditor

An individual (whether internal or external to the firm) who has practical audit experience, and a reasonable understanding of:

- Audit processes
- SAs and applicable legal & regulatory requirements
- Business environment in which entity operates
- Auditing and financial reporting issues

Auditor shall also record:

- The identifying **characteristics** of the **specific items or matters tested;**
- **Who performed** the audit work and the date such work was completed;
- **Who reviewed** the audit work performed and the date and extent of such review?

If the auditor identified inconsistent information, the auditor shall document how the auditor addressed the inconsistency.

1.2.3 Departure from SAs

If, in exceptional circumstances, the departures from SA, the auditor shall document the reasons for the departure and alternative procedures performed.

1.2.4 Matters arising after the Date of the Auditor's Report

If, in exceptional circumstances, the auditor performs new or additional audit procedures or draws new conclusions after the date of the auditor's report, the auditor shall document:

- The circumstances encountered;
- The new or additional audit procedures performed, audit evidence obtained, and conclusions reached, and their effect on the auditor's report; and
- When and by whom the changes to audit documentation were made and reviewed.

1.3 Time limit for Documentation

Auditor should, ideally document contemporaneously. That means as the work is being done, documentation should happen simultaneously.

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The auditor shall finally assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report.

Assembly of final audit file:
SQC-1 requires firm to establish policies and procedures for timely completion of assembly of audit files.

SQC 1 suggests maximum period of **60 days** from the date of auditor's report for completion of assembly of audit files

Preparation Period ➔ Within 60 days from the date of audit period.
Retention Period ➔ Minimum 7 years from the date of audit period.

After the assembly, the auditor shall not delete audit documentation before the end of its retention period.

1.4 Ownership of Audit Documents

Auditor owns audit documents but he can make copies available to the client or to any person authorized by the client.

Auditor is prohibited from disclosing confidential client information without management consent.

The auditor's property rights are subject to limitations of the Chartered Accountants Act, 1949, which prohibits disclosure of confidential client information without the managements consent except when required by the law.

As per SQC – 1, unless otherwise specified by law or regulation, Audit documentation is the property of the auditor.

1.5 Retention of Audit Documentation

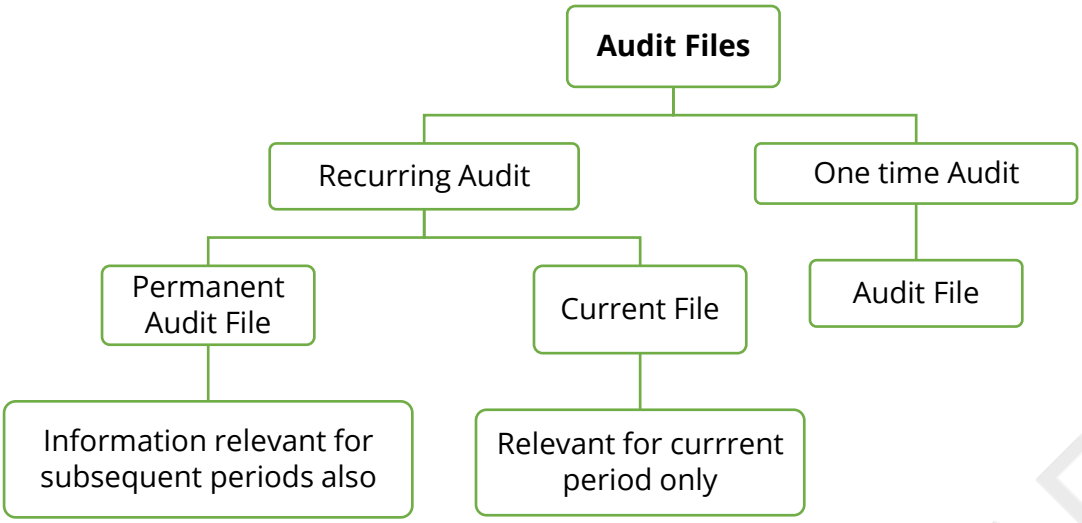
There are no explicit rules relating to the retention of working papers. They should be retained as long as the auditor opines them to be useful in servicing the client or to comply with legal or professional requirements.

SQC 1 requires retention of working papers to be at least for **7 years** from the date of auditor's report.

1.6 Filing of working papers

Although audit of each entity is unique in itself, a general approach to the arrangement/ organization of working papers can be adopted.

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1.6.1 Permanent Audit File

Permanent audit file should contain information, which is of continuing interest and relevance to succeeding audits.

Much of the information contained in this file is collected in the first audit and is updated for each subsequent audit.

Contents of Permanent Audit File

- Information regarding legal and organizational structure of the entity (e.g. partnership deed in case of a partnership firm).
- Extracts or copies of important legal documents, agreements and minutes relevant to the audit (e.g. lease agreement, contracts with major suppliers and so on).
- Record of study and evaluation of internal controls related to accounting system (e.g. flow charts, questionnaires, narrative descriptions and observations concerning the strengths, weaknesses and action taken by the company to eliminate weaknesses).
- Copies of audited financial statements for previous years.
- Analysis of significant ratios and trends (e.g. changes in ratios such as gross profit, current ratio and rate of return on shareholder's equity helps the auditor in identifying areas where there are unusual changes during the year, and which require special attention).
- Copies of management letters issued by the auditor, if any (e.g. management letter).
- Record of communication with the retiring auditor, if any.
- Notes regarding significant accounting policies.
- Significant audit observations of earlier years.

1.6.2 Current File

Current audit file contains information relating to and relevant to the audit of current period. The following information may be filed in the current audit file:

- Correspondence relating to acceptance of annual re-appointment.
- Extracts of important matters in the minutes of the board meetings and general meeting as are relevant to audit (e.g. minutes relating to declaration of dividend).

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- Audit plan and audit program.
- Analysis of transactions and balances (e.g. age- wise analysis of debtors).
- Record of audit procedures and their results (e.g. test checking of purchase invoices to vouch payments for purchases).
- Evidence regarding the supervision and review of the work of assistants.
- Copies of communication with other auditors (e.g. branch auditor), experts (e.g. lawyers, architects) and other third parties (e.g. banks, debtors).
- Copies of letters or notes concerning audit matters communicated to or discussed with client.
- Management representations.
- Auditor's conclusions regarding significant matters.
- Copies of financial statements being reported on and the related audit report.



It is not necessary to document separately compliance with SAs if it is demonstrated by documents included within the audit file.

Documentation of the professional judgments made explain the auditor's conclusions and are required for

(i) reviewing audit documentation,

(ii) subsequent audits, when reviewing matters of continuing significance

1.6.3 Audit Completion Memorandum

It is a summary of audit approach planned and performed including the results and conclusions.

It helps auditors to consider whether the conclusions reached are appropriate and backed with appropriate supporting.

1.7 Audit Note Book

Audit Note Book contains information regarding day-to-day work performed by the audit staff on any particular date. It is maintained by the audit staff to record important points observed, errors, doubtful queries, explanations and clarifications to be received from the clients.

Audit note book should contain General information & current information.

1.7.1 General Information

- Nature of business
- Important provisions of MOA & AOA
- Structure of organisation
- List of books of accounts
- Name of principal officers, duties and responsibilities
- Particulars of accounts and internal controls, financial policies
- Significant contracts

1.7.2 Current Information

- Audit queries not cleared
- Mistakes or irregularities observed
- Unsatisfactory book-keeping arrangements
- Important information about company, not forming part of the accounts
- Special points requiring consideration at the time of verification of final accounts

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- Important matters for future reference.

Completion Memorandum or Audit Documentation Summary

i. The auditor may consider it helpful to prepare and retain as part of the audit documentation a summary (sometimes known as a completion memorandum) that describes-

- the significant matters identified during the audit and
- how they were addressed.

ii. Such a summary may facilitate effective and efficient review and inspection of the audit documentation, particularly for large and complex audits.

iii. The preparation of such a summary may assist auditor's consideration of the significant matters.

iv. It may also help the auditor to consider whether there is any individual relevant SA objective that the auditor cannot achieve that would prevent the auditor from achieving the overall objectives of the auditor.

Ownership of Audit Documentation

- Standard on Quality Control (SQC) 1 provides that, unless otherwise specified by law or regulation, audit documentation is the property of the auditor.
- He may at his discretion, make portions of, or extracts from, audit documentation available to clients, provided:
  - *(i)* such disclosure does not undermine the validity of the work performed, or,
  - *(ii)* in the case of assurance engagements, the independence of the auditor or of his personnel.

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SA 500 – Audit Evidence

1.1 Introduction

Audit evidence includes both information contained in the accounting records underlying the financial statements and other information.

Audit Evidence - Information used by the auditor in arriving at the conclusions on which the auditor's opinion is based.

1.2 Audit Evidence and Auditor's objective

1.2.1 SA 200

The auditor's objective is to give an opinion on the financial statements and for that

- The auditor should obtain sufficient appropriate audit evidence through the performance of compliance and substantive procedures to enable him to draw reasonable conclusions and then the opinion on the financial information"

- The auditor should review and assess the conclusions drawn from the audit evidence obtained and from his knowledge of business of the entity as the basis for the expression of his opinion on the financial information.

Hence from the above we can conclude that auditor's opinion should be supported by reasonable conclusions and reasonable conclusions should be backed by sufficient and appropriate audit evidences.

1.2.2 SA 330

SA 330 requires the auditor to conclude whether sufficient appropriate audit evidence has been obtained.

1.2.3 SA 500

The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence.

1.3 Important Terms

1.3.1 Accounting Records

The records of initial accounting entries and supporting records, such as checks and records of electronic fund transfers; invoices; contracts; the general and subsidiary ledgers, journal entries and other adjustments to the financial statements that are not reflected in journal entries; and records such as work sheets and spreadsheets supporting cost allocations, computations, reconciliations and disclosures.

1.3.2 Management's Expert

An individual or organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements.

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1.4 Significance of Audit Evidence

- The auditor applies his professional judgment to the evidence gathered and obtained during the audit process.
- He forms his opinion as to the truthfulness and fairness of financial statements on the basis of review of such evidence and expresses his opinion through an audit report.

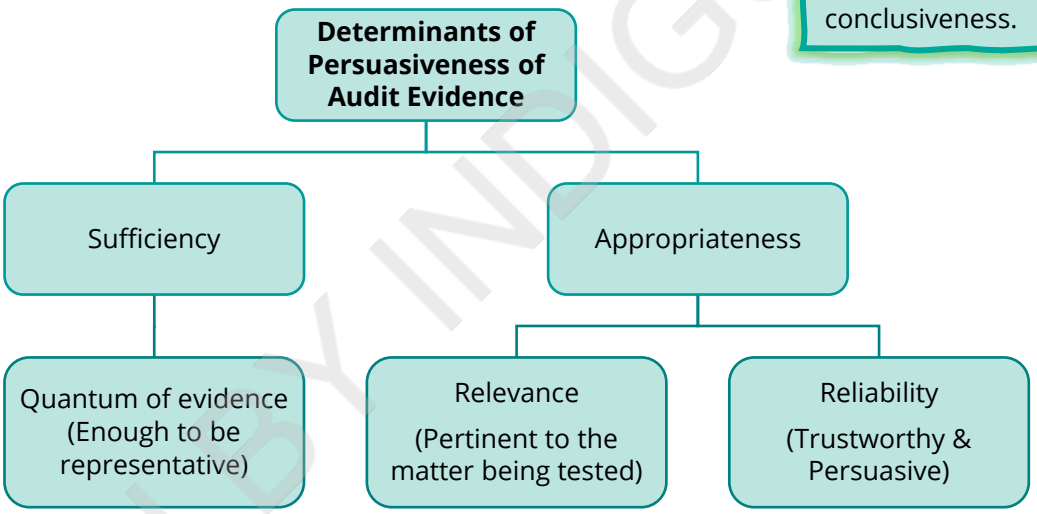
Audit evidence is a fundamental constituent of an audit process.

Audit evidence can be any **document, record or information**, which is available **to substantiate any assertion** made in financial statements or transactions recorded in the books of account.

1.5 Sufficiency and Appropriateness of Audit Evidence

The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence

The persuasiveness of evidence is far more important than its conclusiveness.



The auditor places more importance on persuasive evidence than conclusive evidence because

- cost of obtaining conclusive evidence may exceed the usefulness of evidence obtained and
- it is widely accepted that audit is designed to provide reasonable not absolute assurance about management's assertions in financial statements.

1.5.1 Sufficiency of Audit Evidence

The measure of the quantity of audit evidence. The quantity of the audit evidence needed is affected by the auditor's assessment of the risks of material misstatement and also by the quality of such audit evidence. viz. at least two evidences are required to conclude about the balance in bank - copy of Bank Statement and bank reconciliation statement);

1.5.2 Appropriateness of Audit Evidence

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The measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based. (Copy of bank statement should be duly certified by the bank manager and BRS shall be passed by Managers account and corresponding entries required have been made in books of accounts).

1.5.3 Professional Judgement

Sufficient Audit Evidence = Quantity of evidence.
(Eg. Testing the 70% of the transactions.)

Appropriate Audit Evidence = Quality of evidence. (relevance & reliability in supporting auditor's conclusion) (Eg. Obtaining 3rd Party confirmations.)

Auditor shall use professional judgment to ascertain whether Sufficient and Appropriate audit evidences have been obtained or not.
It all depends upon how much the item concerned is material, whether risk of misstatement is there or not relating to any item of financial statement, nature and complexity of financial information etc.

1.6 Sources of Audit Evidence

- Some audit evidence is obtained by performing **audit procedures** to test the accounting records
- The auditor may determine whether the accounting records are internally consistent and agree to the financial statements.
- Consistency of audit evidence enhances the audit comfort (i.e. relevance and reliability)

1.7 Audit procedures for obtaining audit evidence

- Auditors' Opinion shall be an outcome of
  - Risk assessment procedures performed;
  - Tests of controls, when required by the SAs or when the auditor has chosen to do so; and
  - Substantive procedures, including tests of details and substantive analytical procedures
- The nature and timing of the audit procedures to be used may be affected by the fact that some of the accounting data and other information may be available only in electronic form or only at certain points or periods in time.
- Certain electronic information may not be retrievable after a specified period of time, for example, if files are changed and if backup files do not exist.
  Accordingly, the auditor may find it necessary as a result of an entity's data retention policies to request retention of some information for the auditor's review or to perform audit procedures at a time when the information is available.

1.8 Techniques of Audit Evidence

1.8.1 Inspection

- Inspection refers to the examination of records and of documentary evidence such as lease deeds, investment certificates, whether originating from the third parties or the entity and held by either.
- It also indicates physical examination of tangible assets to ensure their actual existence.
- The various records and documents provide evidence of varying degree of reliability depending on their nature and source and effectiveness of internal controls over their processing.

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- Inspection of tangible assets may provide reliable audit evidence with respect to their existence, but not necessarily about the entity's rights and obligations or the valuation of the assets.
- Inspection of individual inventory items may accompany the observation of inventory counting.

1.8.2 Observation

- Observation consists of looking at a process or procedure being performed by others, for example, the auditor's observation of inventory counting by the entity's personnel, or of the performance of control activities.
- Observation provides audit evidence about the performance of a process or procedure but is limited to the point in time at which the observation takes place, and by the fact that the act of being observed may affect how the process or procedure is performed.

1.8.3 External Confirmation

- An external confirmation represents audit evidence obtained by the auditor as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium.

- External confirmation procedures frequently are relevant when addressing assertions associated with certain account balances and their elements.
- However, external confirmations need not be restricted to account balances only.

1.8.4 Recalculation

Recalculation consists of checking the mathematical accuracy of documents or records. Recalculation may be performed manually or electronically.

1.8.5 Reperformance

Reperformance involves the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control.

1.8.6 Analytical Procedures

- Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and non-financial data.
- Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts.

1.8.7 Inquiry

- Inquiry consists of seeking information of knowledgeable persons, financial and non- financial, within the entity or outside the entity.
- Inquiries may be formal written inquiries or informal oral inquiries.
- Evaluating responses to inquiries is an integral part of the inquiry process. Responses to inquiries may provide the auditor with information not previously possessed or with corroborative audit evidence.
- Alternatively, responses might provide information that differs significantly from other information that the auditor has obtained, for example, information regarding the possibility of management override of controls.
- In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional audit procedures
- Although corroboration of evidence obtained through inquiry is often of particular importance, in the case of inquiries about management intent, the information available to support

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management's intent may be limited.

- In these cases, understanding management's past history of carrying out its stated intentions, management's stated reasons for choosing a particular course of action, and management's ability to pursue a specific course of action may provide relevant information to corroborate the evidence obtained through inquiry

- In respect of some matters, the auditor may consider it necessary to obtain written representations from management and, where appropriate, those charged with governance to confirm responses to oral inquiries

Reliability of audit evidence is influenced by its source and by its nature,and is dependent on the individual circumstances under which it is obtained.

1.9 Relevance & Reliability of Information

When designing and performing audit procedures, the auditor shall consider the relevance and reliability of the information to be used as audit evidence.

1.9.1 Relevance

- Relevance deals with the logical connection with, or bearing upon, the purpose of the audit procedure and, where appropriate, the assertion under consideration. The relevance of information to be used as audit evidence may be affected by the direction of testing
- Obtaining audit evidence regarding a particular assertion, for example, the existence of inventory, is not a substitute for obtaining audit evidence regarding another assertion, for example, the valuation of that inventory. On the other hand, audit evidence from different sources or of a different nature may often be relevant to the same assertion.
- Tests of controls are designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.
- Designing tests of controls to obtain relevant audit evidence includes identifying conditions (characteristics or attributes) that indicate performance of a control, and deviation conditions, which indicate departures from adequate performance.
- The presence or absence of those conditions can then be tested by the auditor.
- Substantive procedures are designed to detect material misstatements at the assertion level.

1.9.2 Reliability

- In the existence of effective internal controls, reliability of internal evidence increases
- Audit evidence obtained directly by the auditor is more reliable than audit evidence obtained indirectly or by inference.
- Written evidence more reliable than oral.
- Following is the level of reliability based on the source of information (external or internal source to the entity) and the destination (external destination means received by the auditor directly) of the information:

Evidence from independent external source is more reliable than that from internal source

Type of Audit evidence	Example	Ranking of reliability
External Source – External Destination	Debtor balance confirmation	1
External source – Internal Destination	Purchase Invoice	2
Internal Source – External Destination	Sales Invoice	3
Internal Source – Internal Destination	Goods receipt note	4

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1.10 Using Management's Expert opinion as evidence

When information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes ensure the following:

1.10.1 Evaluate competence, capabilities and objectivity of the expert

- Personal experience with previous work of that expert
- Discussions with that expert
- Discussions with others who are familiar with that expert's work.
- Knowledge of that expert's qualifications, membership of a professional body or industry association, license to practice, or other forms of external recognition.
- Published papers or books written by that expert.

When evaluating the objectivity, determine any interests and relationships that may create threats to the expert's objectivity, and evaluate whether the safeguards are adequate. Interests and relationships creating threats may include:

- Financial interests.
- Business and personal relationships.
- Provision of other services.

1.10.2 Obtain understanding of the work of the expert

- Whether that expert's field has areas of specialty within it that are relevant to the audit
- Whether any professional or other standards, and regulatory or legal requirements apply
- What assumptions and methods are used by the management's expert, and whether they are generally accepted within that expert's field and appropriate for financial reporting purposes
- The nature, scope and objectives of that expert's work;
- The respective roles and responsibilities of management and that expert;

1.10.3 Evaluate appropriateness of that expert's work as audit evidence for the relevant assertion

- The relevance and reasonableness of that expert's findings or conclusions, their consistency with other audit evidence, and whether they have been appropriately reflected in the financial statements;
- If that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods; and
- If that expert's work involves significant use of source data, the relevance, completeness, and accuracy of that source data.

1.11 Information produced by the entity used by Auditor

When any information is produced by the entity which becomes the audit evidence, the auditor shall ensure

- Accuracy and completeness of evidence
- Evaluating whether information is precise and detailed for the auditor's purpose

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1.12 Test of Controls

In designing and performing test of controls, the auditor shall:

- Perform other audit procedures in combination with inquiry to obtain audit evidence about the operating effectiveness of the controls, including:
  - How the controls were applied at relevant times during the period under audit.
  - The consistency with which they were applied.
  - By whom or by what means they were applied.
- Determine whether the controls to be tested depend upon other controls (indirect controls), and if so, whether it is necessary to obtain audit evidence supporting the effective operation of those indirect controls.

1.12.1 Extent of Test of Controls

Matters the auditor may consider in determining the extent of test of controls include the following:

- The frequency of the performance of the control by the entity during the period.
- The length of time during the audit period that the auditor is relying on the operating effectiveness of the control.
- The expected rate of deviation from a control.
- The relevance and reliability of the audit evidence to be obtained regarding the operating effectiveness of the control at the assertion level.
- The extent to which audit evidence is obtained from tests of other controls related to the assertion.

1.12.2 Timing of Test of Controls

The auditor shall test controls for the particular time, or throughout the period, for which the auditor intends to rely on those controls in order to provide an appropriate basis for the auditor's intended reliance.

1.13 Selecting items for Testing for obtaining Audit Evidence

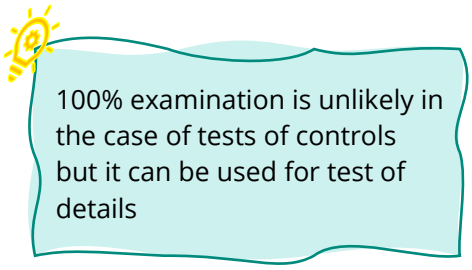
When designing tests of controls and tests of details, the auditor shall determine means of selecting items for testing that are effective in meeting the purpose of the audit procedure.

In selecting items for testing, the auditor is required to determine the relevance and reliability and sufficiency of information to be used as audit evidence.

The means available to the auditor for selecting items for testing are:

- Selecting all items (100% testing)
- Selecting specific items – Targeted Testing
- Audit Sampling

The application of any one or combination of these means may be appropriate depending on the particular circumstances.



1.13.1 100% Testing

100% examination may be appropriate when, for example:

- The population constitutes a small number of large value items;
- There is a significant risk and other means do not provide sufficient appropriate audit evidence; or
- The repetitive nature of a calculation or other process performed automatically by an

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information system makes a 100% examination cost effective.

1.13.2 Selecting Specific Items

The judgmental selection of specific items is subject to non-sampling risk. Specific items selected may include:

- High value or key items.
- All items over a certain amount.
- Items to obtain information.

1.13.3 Audit Sampling

Audit sampling is designed to enable conclusions to be drawn about an entire population on the basis of testing a sample drawn from it.

1.14 Specific Enquiries by auditor when deviations from controls are detected

When deviations from controls upon which the auditor intends to rely are detected, the auditor shall make specific inquiries to understand these matters and their potential consequences, and shall determine whether:

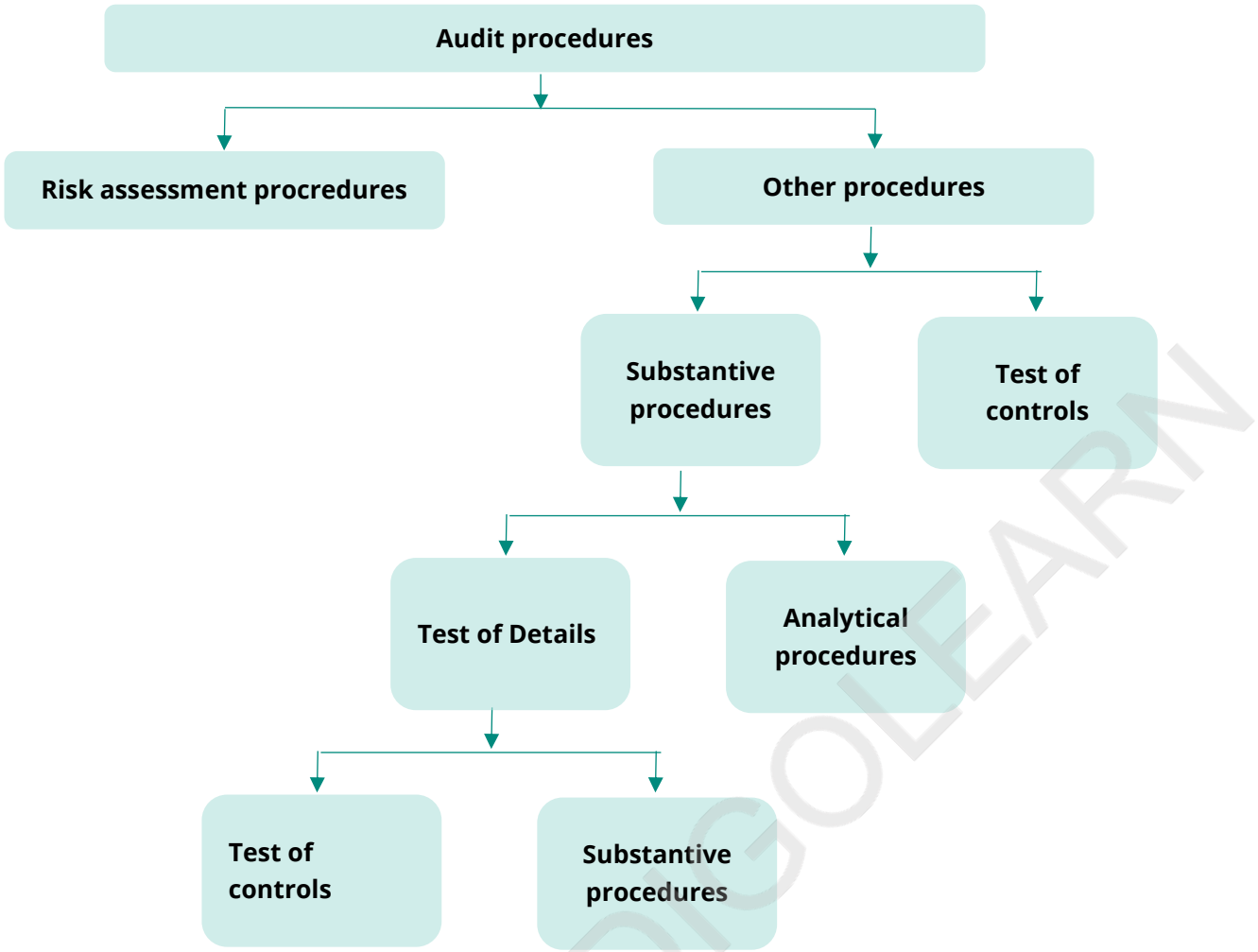
- The test of controls that have been performed provide an appropriate basis for reliance on the controls;
- Additional test of controls is necessary; or
- The potential risks of misstatement need to be addressed using substantive procedures.

1.15 Substantive Procedures

Substantive procedure may be defined as an audit procedure designed to detect material misstatements at the assertion level. Substantive procedures comprise:

- Tests of details (of classes of transactions, account balances, and disclosures), and
- Substantive analytical procedures.

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1.16 Using Audit Evidence obtained in Previous Audits

In determining whether it is appropriate to use audit evidence about the operating effectiveness of controls obtained in previous audits, and, if so, the length of the time period that may elapse before retesting a control, the auditor shall consider the following:

- The effectiveness of other elements of internal control, including the control environment, the entity's monitoring of controls, and the entity's risk assessment process;
- The risks arising from the characteristics of the control, including whether it is manual or automated;
- The effectiveness of general IT-controls;
- The effectiveness of the control and its application by the entity, including the nature and extent of deviations in the application of the control noted in previous audits, and whether there have been personnel changes that significantly affect the application of the control;
- Whether the lack of a change in a particular control poses a risk due to changing circumstances; and
- The risks of material misstatement and the extent of reliance on the control.

1.17 Inconsistency in, Doubts over Reliability of Audit Evidence

The auditor shall determine what modifications or additions to audit procedures are necessary to resolve the following:

- audit evidence obtained from one source is inconsistent with that obtained from another; or
- the auditor has doubts over the reliability of information to be used as audit evidence

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Auditor shall consider the effect of the matter, if any, on other aspects of the audit.

1.18 Financial Statement Assertions

Management makes the assertions and the auditor verifies by obtaining sufficient and appropriate audit evidence.

Assertion	Example of Audit Evidence
Existence	• Existence of inventory may be tested through the auditor's observation of inventory items • Physical verification of Fixed Assets • Debtors may be tested through the auditor's observation of inventory items
Rights &Obligation	• Ownership of inventory can be verified through examining the documents as to title and inquiring about consignment activity • Examine the debt instrument giving rise to liability for testing obligation assertion
Accuracy	• Confirming that the amount in the voucher / invoice is correctly recorded in the books of account
Occurrence	• Sales may be tested for occurrence by examining the invoices and cancelled cheques supporting them. These documents indicate that sales are results of exchange of goods or services for a valid asset
Completeness	• Completeness of accounts payable is usually tested by confirmations with the creditors and by tracing payments to creditors made after year- end to corresponding initial recording of the debt
Valuation	• Debtors should be shown in the balance sheet at net realization value i.e. Gross debtors less provision for bad and doubtful debts to meet the valuation assertion.
Measurement	• As per measurement assertion, interest earned on debentures must be allocated to the accounting period it was earned in, whether it has actually been received or not
Presentation & Disclosure	• Assets pledged as collateral for a debt should be disclosed in the financial statements. • Similarly, AS- 18, requires the disclosure of related party transactions in the financial statements.

1.19 Question

1) Audit evidence includes both information contained in the accounting records underlying the financial statements and other information. Discuss. [RTP-May 18]
2) Auditing is a logical process. An auditor is called upon to assess the actualities of the situation, review the statements of account and give an expert opinion about the truth and fairness of

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such accounts. This he cannot do unless he has examined the financial statements objectively. He needs evidence to obtain information for arriving at his judgment. Discuss explaining clearly the detailed meaning of audit evidence. [RTP-Nov. 19]

3) Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence. Explain. [RTP-Nov. 18]
4) Audit evidence is necessary to support the auditor's opinion and report. It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit. Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence. Explain. [RTP-Nov. 19]
5) What do you mean by sufficient appropriate audit evidence? State various factors that help the auditor to ascertain as to what is sufficient appropriate audit evidence. [Nov. 10 (6 Marks)]
6) State various factors that help the auditor to ascertain as to what is sufficient and appropriate audit evidence. [Nov. 17 (4 Marks)]
7) The quantity of audit evidence needed is affected by the auditor's assessment of the risks of misstatement. Auditor's judgment as to sufficiency may be affected by few factors. Explain. [RTP-May 18]
8) The quantity of audit evidence needed is affected by the auditor's assessment of the risks of misstatement (the higher the assessed risks, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Obtaining more audit evidence, however, may not compensate for its poor quality. Analyse and Explain stating clearly the factors affecting the auditor's judgement as to sufficiency of audit evidence. [RTP-May 19]
9) What are the audit procedures to obtain audit evidence? Mention the same in brief.
10) Explain various methods to obtain audit evidence. [May 11 (8 Marks)]
11) Write short note on: Methods to obtain audit evidence. [May 15 (4 Marks)]
12) Mr. A was appointed statutory auditor of P Ltd. but he was not able to gather the sufficient audit evidences. Discuss how he should proceed to gather more audit evidences. [Nov. 15 (6 Marks)]
13) Discuss the following: Inquiry is one of the audit procedure to obtain audit evidence. [May 13 (5 Marks)]
14) Evaluating responses to inquiries is an integral part of the inquiry process. Explain. [RTP-May 18]
15) Distinguish between: Internal Evidence and External Evidence. [Nov. 08 (6 Marks)]
16) With reference to SA 500, "Audit Evidence", discuss the different sources and their reliability, of audit evidence. [May 17 (6 Marks)]
17) "Even when information to be used as audit evidence is obtained from sources external to the entity, circumstances may exist that could affect its reliability". Explain. Also state clearly generalisations about the reliability of audit evidence. [RTP-May 18]

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- **Audit Risk**

1.1 Audit Risk & Risk of Material misstatement

- **Audit Risk**

Risk means deviation from expectation. It denotes the possibility that the objective might not be met.

> Audit risk means the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated.

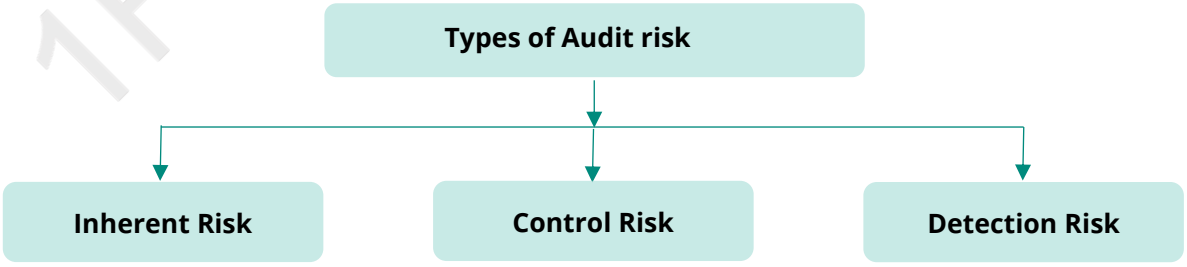
- Audit risk does not include the risk that the auditor might express an opinion that the financial statements are materially misstated when they are not. This risk is ordinarily insignificant.
- Further, audit risk is a technical term related to the process of auditing; it does not refer to the auditor's business risks such as loss from litigation, adverse publicity, or other events arising in connection with the audit of financial statements.

> Misstatement refers to a difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.

Risk of Material Misstatement may exist at two levels

(i) **The overall financial statement level**: refer to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions.
(ii) **The assertion level for classes of transactions, account balances, and disclosures**: are assessed in order to determine the nature, timing, and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence

- **Types of Audit risk- Components of Audit Risk**



The risk of material misstatement at assertion level comprises of two components i.e., inherent risk and control risk. Both inherent risk and control risk are the entity's risks and they exist independently of the audit of financial statements.
Inherent risk and control risk are influenced by the client.

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These are entity's risks and are not influenced by the auditor.

- **Inherent Risk**

  - Inherent risk is the susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements before consideration of any related controls as described in SA-200.
  - There is always a risk that before considering any existence of internal control in an entity, a particular transaction, balance of an account or a disclosure required to be made in the financial statements of an entity have a chance of being misstated and such misstatement can be material. This risk is known as inherent risk.
  - Inherent risk is higher for some assertions and related classes of transactions, account balances, and disclosures than for others. For example, it may be higher for complex calculations.
  - Management will decide on the level of controls based on the inherent risks identified.
  - Inherent risks are based on size and nature of business. Thus, ***management is responsible for planning and implementing controls based on the size and nature of business.***
  - External circumstances giving rise to business risks may also influence inherent risk. For example, technological developments might make a particular product obsolete.

- **Control risk**

  - It is risk of controls designed by management being ***weak or non-existent*** and thereby not arresting inherent risk.
  - Control risk is the risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, ***will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.***
  - Control risk is a risk that internal control existing and operating in an entity would not be efficient enough to stop from happening, or find and then rectify in an appropriate time.
  - When efficiency of internal control of an entity is high, the control risk is low and when efficiency of internal control of that entity is low, the control risk is high.
  - Inherent risk and control risk are the entity's risks; they exist independently of the audit of the financial statements.

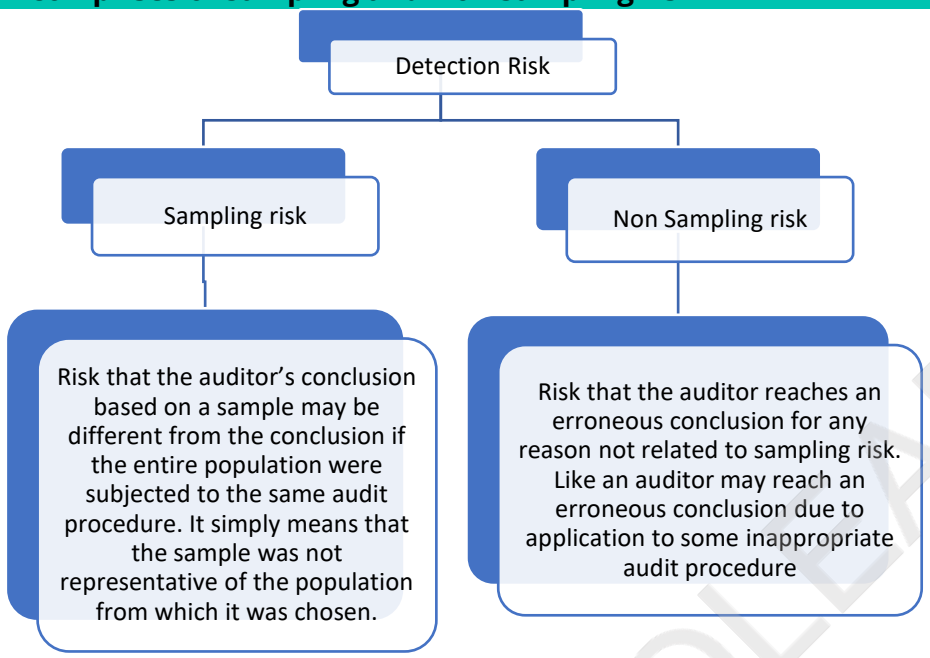
- **Detection risk**
  - Risk that procedures performed by auditor to reduce audit risk to an acceptably low level will ***not detect a misstatement that exist,*** and which could be ***material either individually or when aggregated*** with other misstatements.

Assessment of Risk- Matter of Professional Judgement

- The assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement. The distinguishing feature of the professional judgment expected of an auditor is that it is exercised by an auditor whose training, knowledge and experience have assisted in developing the necessary competencies to achieve reasonable judgments

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Detection risk comprises of Sampling and Non Sampling risk



- **Risk of Material misstatement**

Risk of Material misstatement is the combined assessment of Inherent and Control Risk.

Risk of Material Misstatement (ROMM)= Inherent

Overall Audit Risk= ROMM + Detection Risk

There has to be an inverse relationship between ROMM and Detection risk to bring the audit risk to an acceptable lower level.

2. Risk Assessment and Audit Procedures

Risk assessment procedure - *A basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels.*

- ***Enquiries of management and others within the entity*** **-** helps to understand what they perceive as the risk factors. The auditor should enquire not only the management and those charged with governance but also internal auditors, legal counsels, and employees of all departments like marketing and sales personnel, information system personnel etc.

- ***Use of analytical procedures*** **–** Implies using ratios, trends etc to see what the new risk factors are. Analytical procedures performed as risk assessment procedures may include both financial and non-financial information. It helps to identify the existence of unusual transactions or events, and amounts.

- ***Observation and inspection*** **–** This support the inquiries of management and others. This includes observation or inspection of:

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- The entity's operations
- The entity's premises and plant facilities.
- Reports prepared by management (such as quarterly management reports and interim financial statements) and those charged with governance (such as minutes of board of directors' meetings).

- ***Information obtained in prior periods*** **–** The auditor should check his working papers for all the previous years. This will give him an information of critical areas and about the strength of the internal control. For example, if any fraud was noticed in the last year, then the auditor has to be more cautious in that area for the current year also.
- ***Discussion among engagement teams*** **-** understanding of the entity, its environment and the risk assessment is a continuous process. So, the auditor should ensure free flow of communication and regular discussion with the engagement team. This will help him focus on all areas involving risk.

SA 315- Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment

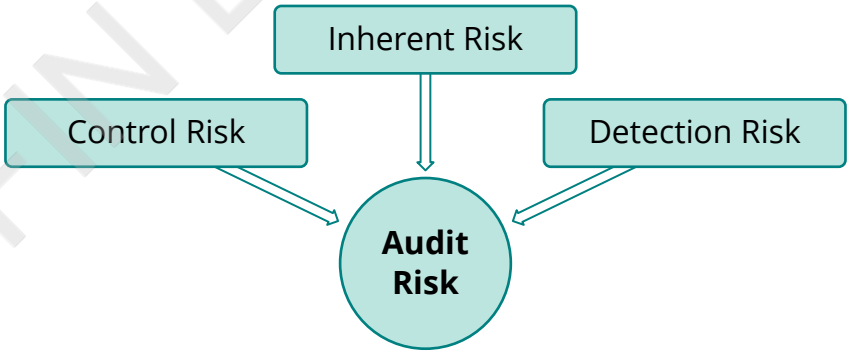
Contents

- Risk & Risk assessment procedures
- Understanding of the Entity and its Environment
- Understanding Internal control
- Risk of Material Misstatement
- Auditor's Responsibility

Introduction - Risk

Auditor's objective is to identify and assess the risks of material misstatement in the financial statements, through understanding the entity and its environment, including the entity's internal control

Risk is deviation from Expectation



Inherent Risk

Inherent risk is the risk of misstatement in the financial statements, arising due to an error or omission as a result of factors other than a failure of

The susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements,

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before consideration of any related controls. Inherent risk arises on account of nature of financial reporting & auditing.

- **Control Risk**

Risk of controls designed by Management, being weak or non-existent, and thereby, not arresting the inherent risk, is called **Control Risk**

Control Risk arises on account of Inherent limitations of internal control. The risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control entirely.
Internal control can provide only reasonable, but not absolute, assurance on account of several inherent limitations.

- **Detection Risk**

Risk that procedures performed by Auditor to reduce Audit Risk to an acceptable low level, will not detect a misstatement that exists, that could be material, either individually or when aggregate d with other misstatements is

Detection risk arises on account of judgement on part of auditor, test nature of audit and nature of audit evidences collected.

- **Relationship between Components of Audit Risk**

  - **Risk of Material Misstatement (RMM) and Internal & Control Risk**

Management often reacts to inherent risk situations by designing accounting and internal control systems to prevent or detect and correct misstatements and therefore, in many cases, inherent risk and control risk are highly interrelated. In such situations, if the auditor attempts to assess inherent and control risks separately, there is a possibility of inappropriate risk assessment.

  - **Risk of Material Misstatement and Detection Risk**

Risk of Material Misstatements (RMM) = Inherent Risk + Control Risk.

There is an inverse relationship between detection risk and the combined level of inherent and control risks. When inherent and control risks are high, acceptable detection risk needs to be low to reduce audit risk to an acceptably low level. When inherent and control risks are low, an auditor can accept a higher detection risk and still reduce audit risk to an acceptably low level.

- **Important Terms**

- **Assertions**

Representations by management that are embodied in the financial statements. These are used by the auditor to consider different types of potential misstatements that may occur.

Assertions : **Transactions during the year**	Assertions : **Account balances at the period end**	Assertions : **Presentation and Disclosure**
• Occurrence • Completeness • Accuracy • Cut-off • Classification	• Existence • Rights and obligations • Completeness • Valuation and allocation	• Occurrence and Rights & obligations • Completeness • Classification and understandability • Accuracy and Valuation

- **Business Risk**

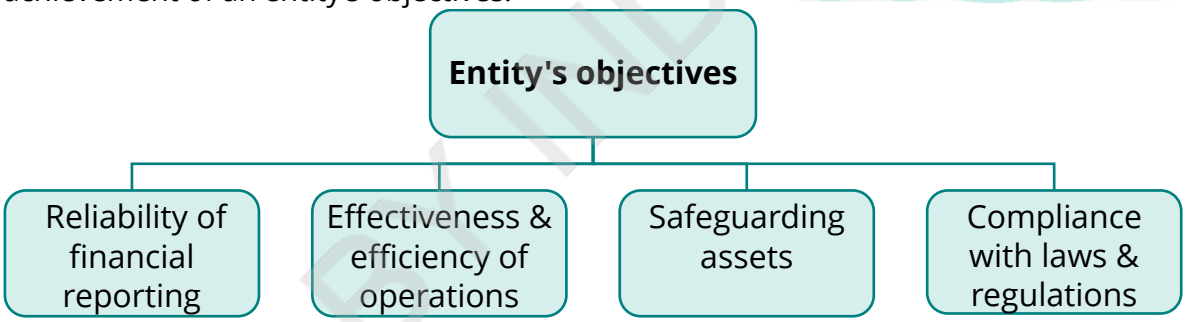
A risk resulting from significant conditions, events, circumstances etc. This risk could adversely affect an entity's ability to achieve or set objectives and execute its strategies.

- **Internal Control**

The process designed, implemented and maintained by
- TCWG,
- management and
- other personnel

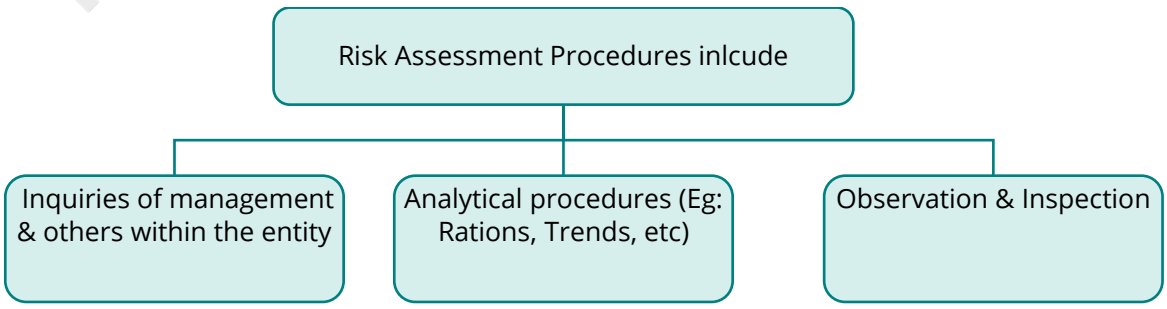
to provide reasonable assurance about the achievement of an entity's objectives.

Effective internal controls help achieve entity's objective



- **Risk Assessment Procedures**

Audit procedures performed to
- Obtain understanding of entity and its environment including the entity's internal control;
- To identify and assess the risks of material misstatement at the financial statement and assertion levels.



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Information obtained in prior periods (may provide auditor with information about matters such as past misstatements and their correction. Nature of entity and its environment, etc.). He should asses the relevance of such information in present period.

Discussion among the engagement team

The engagement partner and other key engagement team members shall discuss the susceptibility of the entity's financial statements to material misstatement, and the application of the applicable financial reporting framework to the entity's facts and circumstances.

- **Significant Risk**

An identified and assessed risk of material misstatement. In auditor's judgment it requires special audit consideration.

> Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion.

- **Material Weakness**

A weakness in internal control that could have a material effect on financial statements.

Understanding of the Entity and its Environment, including the Entity's Internal Control

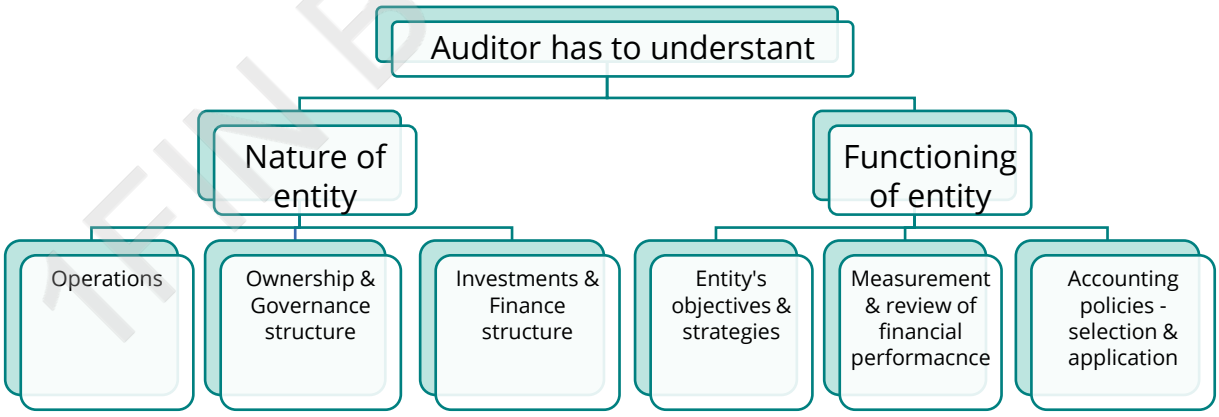
Auditor needs to understand

- Entity's nature and operations
- Environment in which the entity exists
- Entity's Internal Control

to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements

- **Entity**

Auditor has to understand the nature and functioning of the entity.

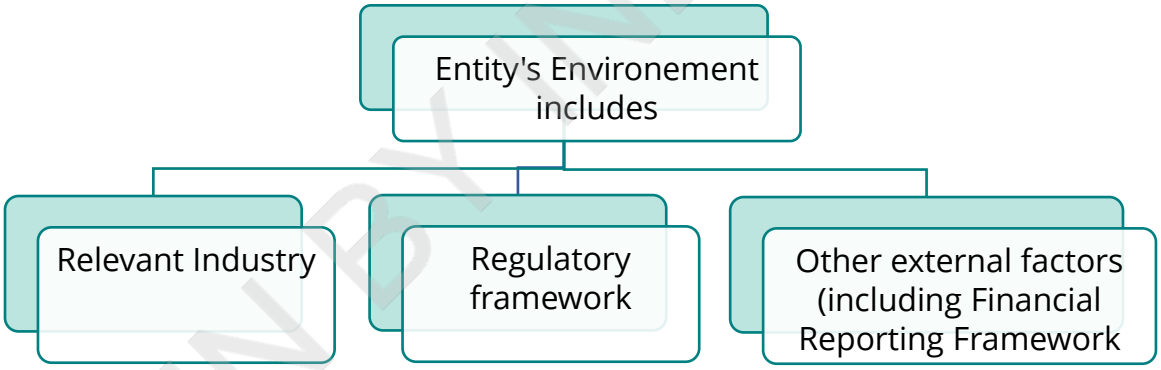


Factor	Aspects to understand

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Business operations	▪ **Nature of revenue sources, products or services and market;** ▪ **Conduct of operations** ▪ **Alliances, Joint ventures and outsourcing activities** ▪ **Geographic dispersion and industry segmentation** ▪ **Transactions with related parties.**
Investments and investment activities	▪ **Planned or recently executed acquisitions** ▪ **Investments and disposition of securities or loan** ▪ **Capital investment activities** ▪ **Investments in non-consolidated entities such as special purpose entities**
Financing and financing activities	• **Major subsidiaries and associated entities** • **Debt structure** • **Beneficial owners and related parties** • **Use of derivative financial instruments.**
Financial reporting	• **Accounting principles and industry specific practices** • **Revenue recognition practices** • **Accounting for fair values** • **Foreign currency assets, liabilities and transactions.**

- **Entity's Environment**

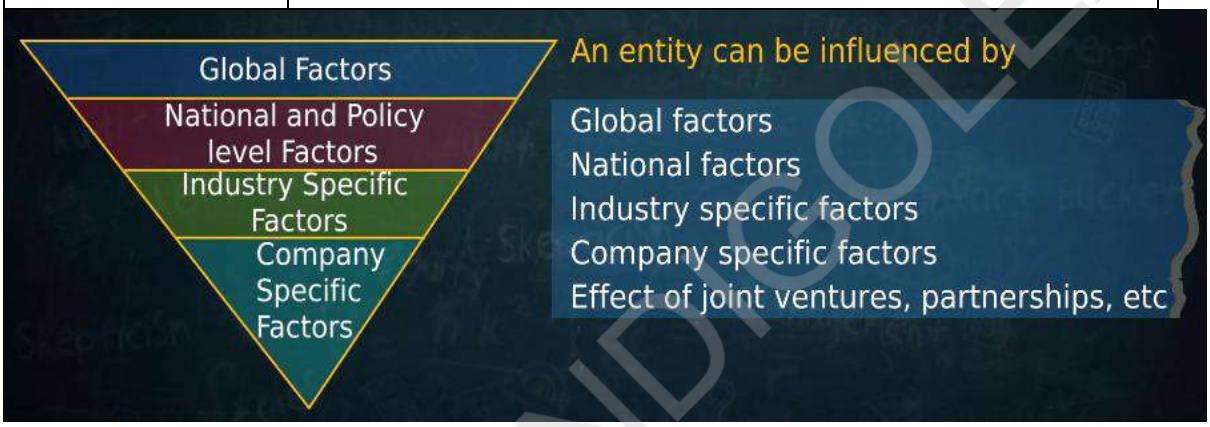


The auditor should obtain understanding the factors to assess risk

Factor	Aspects to understand
Industry factors	• **Competitive environment** • **Supplier and customer relationships.** • **Technological development.** • **Cyclical or seasonal activity**

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Regulatory factors	• **Accounting principles and industry specific practices** • **Regulatory framework** • **legislation and regulation affect entity's operations** • **Legislation and regulation affect entity's operations** • **Taxation** • **Government policies**
External factors	• **General economic conditions** • **Interest rates** • **Availability of financing** • **Inflation.**



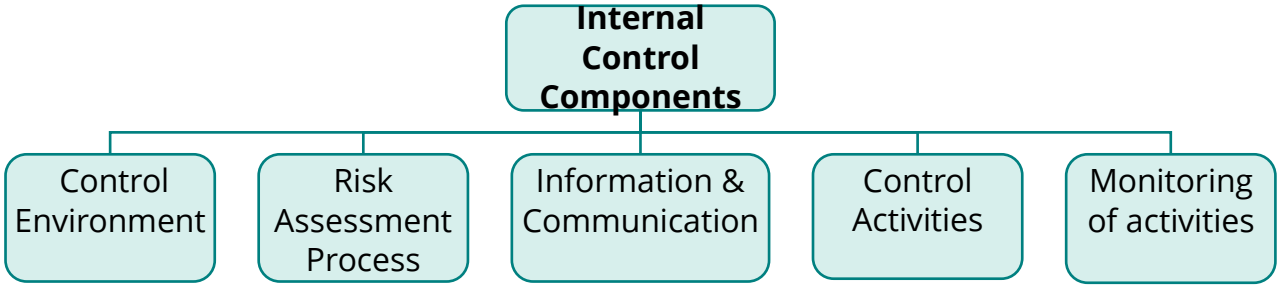
- **Internal Control System**

Auditor, to understand internal controls of the entity has to evaluate the design of relevant controls and ensure they have been implemented by performing procedures SA 315 provides a useful framework for

> Most controls relevant to the audit are likely to relate to financial reporting, but not all controls that relate to financial reporting are relevant to the audit. Auditor uses professional judgement to decide which control is relevant

auditors to consider how different aspects of internal control affect the audit.

There are five components of Internal Control System which the auditor has to understand



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- **Control Environment**

The control environment factors lay the foundation of all other components of the internal control system. They influence the control consciousness of its people. Auditor has to evaluate if the management and TCWG have created and maintained such environment. These factors are:

- Integrity and ethical values;
- Commitment to competence;
- Management's philosophy and operating style;
- Organizational structure;
- Assignment of authority and responsibility;
- Human resource policies and procedures; and
- Participation by those charged with governance.

- **Risk Assessment Process**

For financial reporting purposes an entity's risk assessment process shall have

- Identification
- Analysis as to the significance
- Assessing probability of occurrence and
- management through action

of risks relevant to the preparation of financial statements in accordance with relevant accounting principles.

The following risks may affect an entity's ability to properly record, process, summarize and report financial data:

- Changes in operating environment
- New personal
- New information systems
- Rapid growth
- New Technology
- New business models, products or activities
- Corporate restricting
- Foreign operations
- New accounting pronouncements

Auditor shall understand the existing risk assessment process of the entity, and if a misstatement is noticed, he shall also understand why such process failed or determine deficiency in the internal control

If there is no risk assessment process or entity has an ad hoc process, the auditor shall discuss with management whether business risks relevant to financial reporting objectives have been identified and how they have been addressed

- **Information & Communication**

Auditor has to understand the information system including related business processes relevant to financial reporting

It includes the accounting systems, consisting of the methods/ procedures and records established to record, process, correct, summarize and report entity transactions and to maintain accountability of the related assets and liabilities.

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To be effective, such a system must accomplish following transaction related goals-

- Identify and record all valid transactions
- Describe on a timely basis
- Measurement of proper value
- Record in the appropriate time period
- Properly present and disclose
- Communicate responsibilities to employees
- Capture significant events or conditions (other than transactions) that affect financial statements
- Communications between management and TCWG
- External communications. Eg: regulatory authorities

The records may be in either manual or electronic form. The procedures may be controlled either by automated (IT) or manual systems

- **Control Activities**

The fourth component is composed of the various policies and procedures that help ensure that necessary actions are taken to address risks to achieve the entity's objectives.

These policies and procedures include.

i. Performance reviews (reviews of actual performance against budgets, forecasts, one another, etc.)
ii. Information processing (controls that check accuracy, completeness and authorization of transactions)
iii. Physical controls (activities that assure the physical security of assets and records)
iv. Segregation of duties (separate authorization, record keeping and custody)
v. Response to IT risk

- **Monitoring**

Monitoring assesses the quality of internal control performance over time. It may be

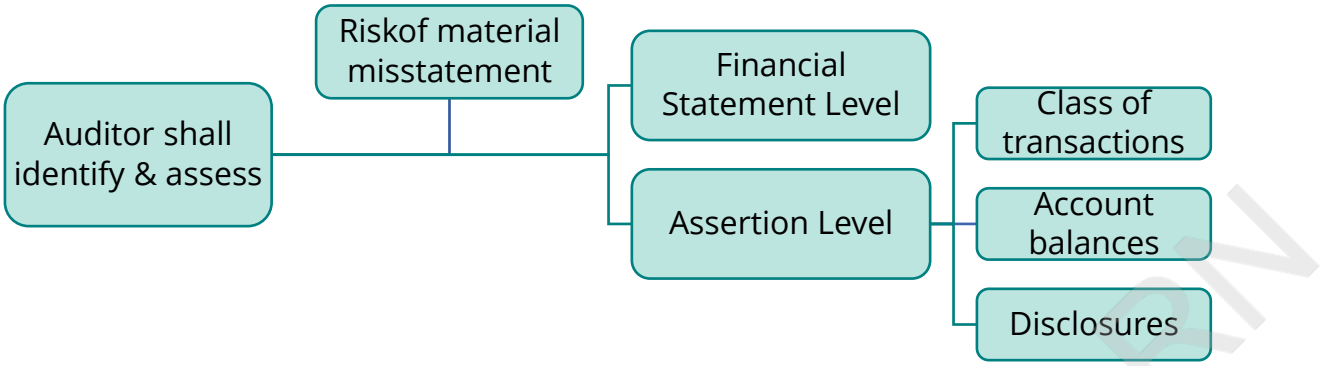
- Ongoing monitoring (designed into recurring activities such as sales and purchases)
- Separate evaluations (performed by auditors or other such internal personnel)
- Evaluation by external parties (e.g. payment of an invoice by a customer corroborates the billing data generated by internal control system).

Auditor shall obtain an understanding the internal audit function in order to determine whether it is likely to be relevant to the engagement. Auditor shall understand:

- Internal audit functions' place in the organisational structure
- Internal auditor's responsibilities
- Activities performed by internal auditor team

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- **Auditor's Responsibility**



- **Audit steps**
  - **Identify risks** during the process of obtaining an understanding of the entity and its environment.
  - **Assess the identified risks** and determine whether these exists misstatement at financial statement level or at assertion level.
  - **Identify controls** that are likely to prevent or detect or correct material misstatement at assertion level.
  - Consider the likelihood of misstatement and **assess its materiality.**

- **Identification of significant risk**
  - As part of risk assessment, the auditor should identify significant risk.
  - If it exists, the auditor shall obtain an understanding of the entity's controls, including control activities, relevant to that risk.
  - Revision of risk assessment – if during the course of audit, the audit's assessment of risk at ascertains level changes, he shall revise the risk assessment and modify further planned audit procedures.

Significant risks often relate to significant non routine transactions

- **No Sufficient Appropriate Audit Evidence**

If it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures for some risks (e.g.: highly automated processing with little or no manual intervention), then auditor shall obtain understanding entity's control over such risks.

- **Revision of Risk Assessment**

If the auditor shall revise the risk assessment and modify planned audit procedures if

- obtains audit evidence from performing further audit procedures, or
- if new information is obtained, either of which is inconsistent with the audit evidence on which the auditor originally based the assessment.

- **Documentation**
  - Discussions with engagement team and significant decisions
  - Key elements of the understanding of entity and its environment and its internal control
  - Sources of information of such understanding
  - Risk assessment procedures performed
  - Risks identified and assessed at both financial statement and assertion levels

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- Risk identified and associated controls

Auditor's approach – Identifying & Assessing RMM

There are 5 main aspects to be addressed

- Assessment of Risks of Material Misstatement at the Financial Statement level
- Assessment of Risks of Material Misstatement at the Assertion level
- The Entity's Selection and Application of Accounting Policies
- Objectives and Strategies and related Business Risks
- Measurement and Review of the Entity's Financial Performance

Assessment of Risks of Material Misstatement at the Financial Statement level

This risk relates pervasively to the financial statements as a whole and may potentially affect many assertions. The following are some factors which may raise doubts about the adaptability of entity' financial statements:

- Management's lack of competence and integrity
- Reliability of an entity's records
- Weak control environment, etc.

Assessment of Risks of Material Misstatement at the Assertion level

The auditor should identify such risks in order to determine the nature, timing and extent of other audit procedures.

The Entity's Selection and Application of Accounting Policies

An understanding of the entity's selection and application of accounting policies including the reasons for changes therein if necessary.

Objectives and Strategies and related Business Risks

The auditor's understanding of the entity's objectives, strategies and related business risks increases the likelihood of identifying risks of material misstatement. Examples of such matters are-

- Industry developments
- New products and services
- Expansion of business
- New accounting requirements, etc.
- Use of IT

Measurement and Review of the Entity's Financial Performance

An understanding of entity's performance measures assists the auditor in considering whether pressures to achieve performance targets may result in management policies that increase the risk of material misstatement. These measures may include-

Budgets
Employee performance measures and incentive compensation policies
Ratios and trends
Analyst's reports
Credit rating agency reports

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Questions

- The assessment of risks is a matter of professional judgment. Explain stating clearly what is not included in Audit Risk? [MTP-Aug. 18]
- "Risk of material misstatement consists of two components" Explain clearly defining risk of material misstatement.
- "The SAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "risks of material misstatement". Explain. [RTP-Oct. 19]
- Obtaining an understanding of the entity and its environment, including the entity's internal control, is a continuous, dynamic process of gathering, updating and analysing information throughout the audit. Analyse and explain giving examples. [RTP-May 20]
- Internal control over safeguarding of assets against unauthorised acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives. Explain stating clearly the objectives of Internal Control. [RTP-May 20]
- When auditor identifies deficiencies and report on internal controls, he determines the significant financial statement assertions that are affected by the ineffective controls in order to evaluate the effect on control risk assessments and strategy for the audit of the financial statements. Explain. [RTP-May 20]
- As part of the risk assessment, the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk. In exercising judgment as to which risks are significant risks, state the factors which shall be considered by the auditor. Explain the above in context of SA-315. [RTP-May 18]
- Discuss what is included in risk assessment procedures to obtain audit evidence about the design and implementation of relevant controls. [RTP-May 18]
- In the context of SA 315, state the assertions used by auditor to consider the different types of potential mis-statements that may occur w.r.t. classes of transactions and events for period under audit. [Nov. 17 (4 Marks)]
- Discuss the following: The assertions used by auditor to consider potential misstatements about account balances at the period end. [Nov. 15 (5 Marks)]
- Discuss in brief the types of audit risk and inter relationship of components of audit risk. [Nov. 14 (4 Marks)]
- Write short note on: Inherent Risk. [Nov. 12 (4 Marks)]
- "Risk of material misstatement at the assertion level for classes of transactions, account balances and disclosures need to be considered". Explain stating the different categories of assertions used by the auditor.
- Explain the concept of Internal Control. Also state the objectives of Internal Control.

SA 320 – Materiality in Planning & Performing an Audit

Contents

- Materiality
- Performance Materiality

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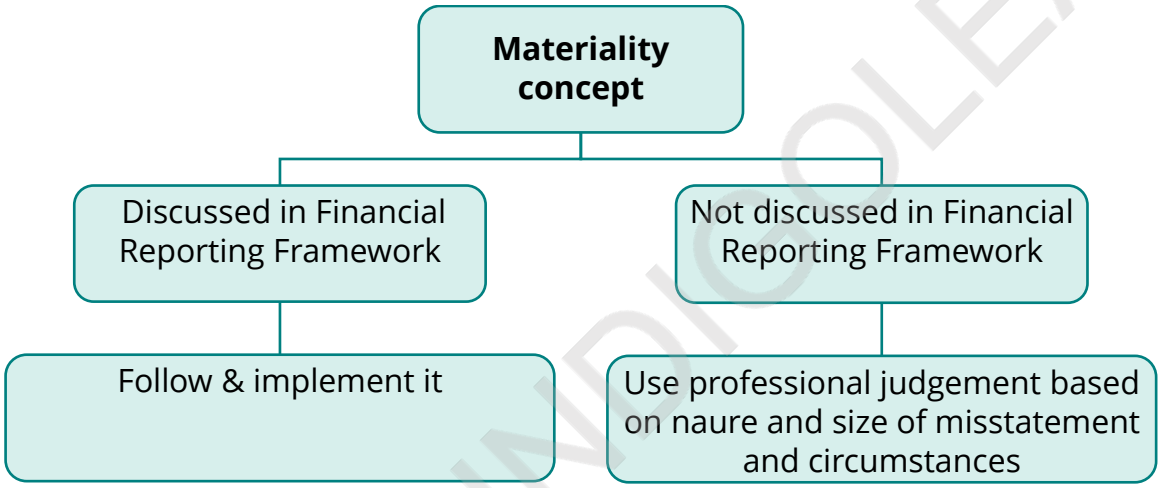
- **Materiality**

The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered only general effect on all users put together is considered.

Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.

Materiality can be of two types – Specific materiality affected by the nature of the item (Eg: Share capital, Reserves balances, statutory items, taxation, legal expenses) and Amount driven materiality which is subjective computation of materiality levels.

Materiality concept may be discussed in the applicable financial reporting framework.



- **Auditor's judgement**

Auditor's judgement about materiality are affected by

- Surrounding circumstances; and
- Size and nature of misstatement

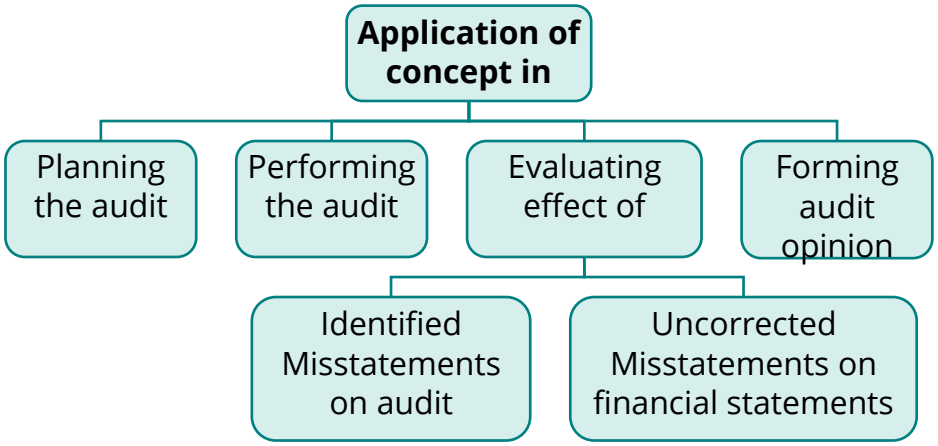
- **Auditor's assumptions**

The auditor's determination of materiality is a matter of professional judgment, and is affected by the auditor's perception of the financial information needs of users of the financial statements.
Auditor, in this regard can assume that users

- Have reasonable knowledge of business and economic activities and accounting and study financial statements with due diligence
- Understand that financial statements are prepared, presented and audited to levels of materiality;
- Recognize inherent limitations associated with accounting estimates and judgements of future events
- Make reasonable economic decisions on the basis of the information

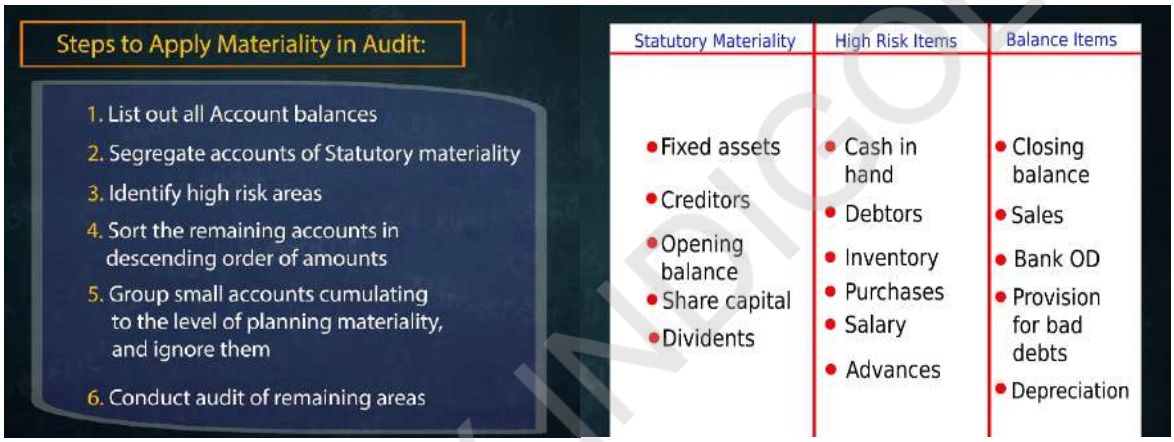
- **Application of concept of Materiality**

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In planning the audit, the auditor makes judgments about the size of misstatements that will be considered material. These judgments provide a basis for

- Determining the nature, timing and extent of risk assessment procedures;
- Identifying and assessing the risks of material misstatement; and
- Determining the nature, timing and extent of further audit procedures



- **Benchmark in determining overall materiality**

For calculating overall materiality, auditor has to choose a benchmark. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole.

Factors that may affect the identification of an appropriate benchmark include the following:

- Elements of the financial statements (for example, assets, liabilities, equity, revenue, expenses);
- Financial statement items that attract attention of users
- The nature of the entity, stage of entity's life cycle, and the industry and economic environment in which the entity operates;
- The entity's ownership structure and the way it is financed
- The relative volatility of the benchmark.

Determining a percentage to be applied to a chosen benchmark involves the exercise of professional judgment. There is a relationship between the percentage and the chosen benchmark, such that a percentage applied to profit before tax from continuing operations will normally be higher than a percentage applied to total revenue.

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Examples

- profit before tax,
- total revenue,
- gross profit and
- total expenses,
- total equity or
- net asset value.

Profit before tax from continuing operations is often used for profit-oriented entities. When profit before tax from continuing operations is volatile, other benchmarks may be more appropriate, such as gross profit or total revenues

- **Planning Materiality**

Planning materiality basically refers to the misstatement amount set by auditors at the planning stage of an audit based on the materiality to financial statements.



Planning Materiality is the adjusted overall materiality level, after considering company

The preliminary estimate of materiality at the financial statement level, often called planning materiality, is the maximum amount by which the auditors believe the statements could be misstated, by known or unknown error or fraud, and still not affect the decisions of reasonable financial statement users. This estimate is only a guide and is not a specific determination of what is, and is not, material in an audit.

Performance Materiality means the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole.

- **Performance Materiality**

Performance materiality is reduced in order to allow for the risk that there may be several smaller errors or omissions that have not been identified by the auditor.

These smaller items could be material when aggregated, so the performance materiality level is set to accommodate them.

If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures

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The level of performance materiality can be set at different levels for different accounts. This has a direct bearing on sample size, since a greatly reduced level of performance materiality will call for significantly larger sample sizes in order to reduce the risk of accepting a sample when the associated population actually contains a material misstatement.

○ Materiality vs Performance Materiality

Planning materiality is the materiality of the financial statements as a whole while Performance materiality is generally a percentage of Planning based on risk and qualitative factors.

Once the auditor identifies and assesses the financial statements' materiality, then the auditor sets the performance materiality (tolerable misstatement) of financial statements. Planning materiality must be larger than performance materiality.

Materiality	Performance Materiality
• Determination of materiality is main goal of overall audit strategy. • Materiality refers to the state where financial information has the ability to affect economic decisions of users if some information is misstated, omitted, or not disclosed • It is for the financial statements as a whole • Materiality is based on needs and expectations of the users of financial information (a group of users; possible effect on specific individual users is not considered), not those of the auditor based on audit risk.	• Determination of performance materiality is conducted for the purpose of assessing audit risk. • Performance Materiality refers to the amount of variation that can exist in individual financial accounts due to errors and omissions without affecting the auditor's opinion regarding the objectivity of financial statements • It is the percentage of Planning materiality based on risk and qualitative factors. • Performance materiality does not have to be set for all individual accounts as this can be done for a selected set of accounts or for a particular class of accounts.

▪ Determination of Materiality

The auditor shall determine materiality for the financial statements as a whole when establishing overall audit strategy.

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But for any class of transactions, account balances or disclosures misstatements of lesser amounts than the materiality determined overall can influence economic decisions of users, the auditor can determine different materiality levels for those.

- **Determination of Performance Materiality**

The auditor shall determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures.

- **Computation**

Usually, a single base such as the higher of total revenues or total assets is selected for the financial statements taken as a whole and multiplied by a percentage factor, to compute the Planning materiality. Next, a percentage factor based on risk at the financial statement level is multiplied with planning materiality amount to determine performance materiality, which is the maximum amount of known error and likely error an auditor can accept in the financial statements without adjustment.

- **Revision as Audit progresses**

The auditor shall revise materiality for the financial statements as a whole or at individual item, if required as and when there is any information to the contrary that he believed while determining materiality initially.

Accordingly, if lower materiality is determined as appropriate, then auditor shall revise performance materiality.

- **Documentation**

Auditor shall document the amounts and the factors considered in determination of:

- Materiality for the financial statements as a whole
- If applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures
- Performance materiality and
- Any revision of materiality amounts and performance materiality

- **Questions**

- Materiality for the financial statements as a whole may need to be revised as a result of a change in circumstances that occurred during the audit. Explain with the help of example. [MTP-Oct. 19]
- Write short note on: Audit Planning and Materiality. [May 13 (4 Marks)]
- Materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) does not need any revision.
- State the factors which are to be considered in determining materiality. [Nov. 15 (4 Marks)]
- Explain concept of materiality and factors which act as guiding factors to this concept. [Nov. 09 (6 Marks)]
- State the factors which are to be considered in determining materiality. [Nov. 15 (4 Marks)]
- Write short note on: Factors affecting the identification of an appropriate benchmark in determining materiality.
- "Determining materiality involves the exercise of professional judgment". Discuss stating the factors that may affect the identification of an appropriate benchmark. Also give examples.

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[RTP-May 18]

- With reference to SA 320 indicate the factors which may affect the identification of an appropriate benchmark in determining materiality for the financial statements as a whole. [Nov. 15 (5 Marks)]
- Materiality for the financial statements as a whole may need to be revised as a result of a change in circumstances that occurred during the audit. Explain with the help of example. [MTP-Oct. 19]

Internal control

- As per SA-315, "Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment",
    - the internal control may be defined as
    - "the process designed, implemented and maintained
    - by those charged with governance, management and other personnel
    - to provide reasonable assurance
    - about the achievement of an entity's objectives with regard to
    - reliability of financial reporting, effectiveness and efficiency of operations, safeguarding of assets, and compliance with applicable laws and regulations

CARE

C: Complaince with laws and Regulation

A: Safegurading of Assets

R: Reliability of Financial Reporting

E: Effectiveness and Efficiency of Operations

3. Purpose of Internal Control:

Internal control is designed, implemented and maintained to address identified business risks that threaten the achievement of any of the entity's objectives that concern:

(i) Identifying types of potential misstatements;

(ii) Identifying factors that affect the risks of material misstatement, and

(iii) Designing the nature, timing, and extent of further audit procedures.

4. Benefits of Understanding Internal Control

An understanding of internal control assists the auditor in: -

(i) Identifying types of potential misstatements;

(ii) Identifying factors that affect the risks of material misstatement, and

(iii) Designing the nature, timing, and extent of further audit procedures.

Limitations of Internal Control

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- ***Internal control can provide only reasonable assurance***
  Internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity's financial reporting objectives. They do not provide absolute assurance. Inbuilt control for unforeseen event is not possible.
- ***Human judgment in decision-making***
  Human judgment in decision-making can be faulty. Human error may result in breakdowns in internal control. The possibility of biased decision cannot be ruled out.
- ***Lack of understanding the purpose***
  The operation of a control may not be effective, such as where information produced for the purposes of internal control (for example, an exception report) is not effectively used because the individual responsible for reviewing the information does not understand its purpose or fails to take appropriate action.
- ***Collusion among People***
  Controls can be circumvented by the collusion of two or more people. Inappropriate management may also override of internal control. For example, management may enter into side agreements with customers that alter the terms and conditions of the entity's standard sales contracts, which may result in improper revenue recognition.
- ***Judgement by Management***
  In designing and implementing controls, management may make judgments on the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume. Management choices can be sub-optimal.
- ***Limitations in case of Small Entities***
  Smaller entities often have fewer employees due to which segregation of duties is not practicable. In a small owner-managed entity, the owner-manager may be able to exercise more effective oversight than in a larger entity. However, the owner-manager may be more able to override controls because the system of internal control is less structured.

Controls relevant to the Audit

There is a direct relationship between an entity's objectives and the controls it implements to provide reasonable assurance about their achievement.

The entity's objectives, and therefore controls, relate to financial reporting, operations, and compliance.

However, not all of these objectives and controls are relevant to the auditor's risk assessment. Factors relevant to the auditor's judgment about whether a control, individually or in combination with others, is relevant to the audit includes the following:

- Principles of Materiality.
- The significance of the related risk.
- The size of the entity and the nature of the entity's business, including its organization and ownership characteristics.
- The diversity and complexity of the entity's operations.
- Applicable legal and regulatory requirements.
- The circumstances and the applicable component of internal control.
- The nature and complexity of the systems that are part of the entity's internal control, including the use of service organizations.

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- Whether, and how, a specific control, individually or in combination with others, prevents, or detects and corrects, material misstatement.

The auditor will delve deep into the following types of control:

5. Controls over the completeness and accuracy of information

Controls over the completeness and accuracy of information produced by the entity is relevant to the audit. For example, in auditing revenue by applying standard prices to records of sales volume, the auditor considers the accuracy of the price information and the completeness and accuracy of the sales volume data. Controls relating to operations and compliance objectives may also be relevant to an audit.

6. Internal control over safeguarding of assets

- Internal control over safeguarding of assets against unauthorized acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives.
- The auditor's consideration of such controls is generally limited to those relevant to the reliability of financial reporting. For example, use of access controls, such as passwords, that limit access to the data and programs that process cash disbursements may be relevant to a financial statement audit.
- Safeguarding controls relating to operations objectives, such as controls to prevent the excessive use of materials in production, generally are not relevant to a financial statement audit.

7. Controls relating to objectives that are not relevant to an audit

- An entity generally has controls relating to objectives that are not relevant to an audit and therefore will not be considered by the auditor. For example, an entity may rely on a sophisticated system of automated controls to provide efficient and effective operations such as an airline's system of automated controls to maintain flight schedules, but these controls ordinarily would not be relevant to the audit.
- Further, although internal control applies to the entire entity or to any of its operating units or business processes, an understanding of internal control relating to each of the entity's operating units and business processes may not be relevant to the audit.
- In certain circumstances, the statute or the regulation governing the entity may require the auditor to report on compliance with certain specific aspects of internal controls as a result, the auditor's review of internal control may be broader and more detailed.

8. Nature & Extent of the understanding of relevant controls

- The auditor has to understand the nature and extent of the relevant Controls.
- ***Evaluating the design of a control*** involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements.
- Implementation of a control means that the control exists and that the entity is using it.
- Risk assessment procedures to obtain audit evidence about the design and implementation of relevant controls may include-

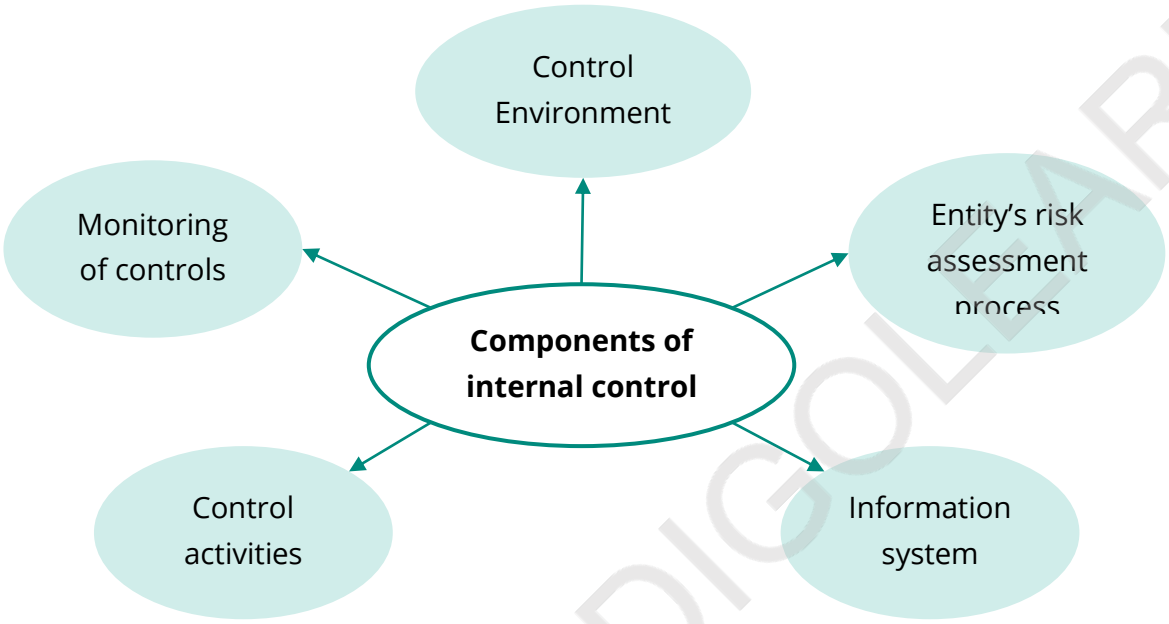
  Inquiring of entity personnel.
  Observing the application of specific controls.
  Inspecting documents and reports.

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Tracing transactions through the information system relevant to financial reporting.

- Inquiry alone, however, is not sufficient for such purposes. He has to personally check if the controls are effectively operating.
- Obtaining an understanding of an entity's controls is not sufficient to ***test their operating effectiveness***, unless there is some automation that provides for the consistent operation of the controls.

Components of internal control



- **Control environment**

- The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether:
  - Management has created and maintained a culture of honesty and ethical behaviour and
  - The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control.
- The control environment includes:
- the governance and management functions and
- the attitudes, awareness, and actions of those charged with governance and management.
- the control environment sets the tone of an organization, influencing the control consciousness of its people.

- Elements of the control environment that may be relevant when obtaining an understanding of the control environment include the following:

- ***Communication and enforcement of integrity and ethical values***
  These are essential elements that ***influence the effectiveness of the design, administration and monitoring of controls***.
- ***Commitment to competence***
  Management's consideration of the competence levels for particular jobs and whether right ***persons with requisite skill and knowledge*** are appointed.

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- ***Participation by those charged with governance***
  It included attributes of those charged with governance such as:
  - Their independence from management.
  - Their experience and stature.
  - The extent of their involvement and the information they receive, and the scrutiny of activities.
  - The appropriateness of their actions, including the degree to which difficult questions are raised and pursued with management, and their interaction with internal and external auditors.
- ***Management's philosophy and operating style***
  It includes Characteristics such as management's:
  - Approach to taking and managing business risks.
  - Attitudes and actions toward financial reporting.
  - Attitudes toward information processing and accounting functions and personnel.
- ***Organizational structure***
  The framework within which an entity's activities for achieving its objectives are planned, executed, controlled, and reviewed.
- ***Assignment of authority and responsibility***
  Matters such as how authority and responsibility for operating activities are assigned and how reporting relationships and authorization hierarchies are established.
- ***Human resource policies and practices***
  Policies and practices that relate to, for example, recruitment, orientation, training, evaluation, counselling, promotion, compensation, and remedial actions.

Impact of Satisfactory Control environment

- The existence of a satisfactory control environment can be a positive factor when the auditor assesses the risks of material misstatement.
- However, although it may help reduce the risk of fraud, a satisfactory control environment is not an absolute deterrent to fraud. Conversely, deficiencies in the control environment may undermine the effectiveness of controls, in particular in relation to fraud.
- The control environment in itself does not prevent, or detect and correct, a material misstatement. It may, however, influence the auditor's evaluation of the effectiveness of other controls and thereby, the auditor's assessment of the risks of material misstatement.

Entity's Risk Assessment Process

- The entity's risk assessment process forms the basis for the risks to be managed.
- If that process is appropriate, it would assist the auditor in identifying risks of material misstatement. Whether the entity's risk assessment process is appropriate to the circumstances is a matter of judgment.
- Risks can arise or change due to factor such as new technology, new business models, products or activities, changes in operating environment etc. Whether the entity's risk assessment process is appropriate to the circumstances is a matter of judgment.
- The auditor shall obtain an understanding of whether the entity has a process for:
  1. Identifying business risks relevant to financial reporting objectives
  2. Estimating the significance of the risks
  3. Assessing the likelihood of their occurrence and
  4. Deciding about actions to address those risks.

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▪ Information system

The auditor shall obtain an understanding of the following:

- The ***classes of transactions*** in the entity's operations that are ***significant to the financial statements.*** Transactions can be divided into categories or classes and then accordingly traced their reporting in financial statements. For example – Based on geographic locations (domestic/ international) based on nature (sales/ purchases), based on means of recording (digital/manual) etc.
- The ***procedures by which those transactions are initiated, recorded, processed, corrected as necessary, transferred*** to the general ledger and reported in the financial statements.
  This refers to the trail of transactions from beginning to end i.e., from its originating source to ultimately appearing in financial statements.



  Understand the controls at each of the above level.
- The related accounting records, ***supporting information*** and specific accounts in the financial statements that are used to initiate, record, process and report transactions.
  This refers to the various supporting documents that gets generated at each level of recording the transaction. For example – For an inventory, the various supporting documents are Purchase order, Invoice, Goods receipt note, Gate pass etc. The auditor has to understand that there is not only a supporting document at each level but also that such document is approved by an authorized person. This can either be under a manual system or an electronic system.
- How the ***information system*** captures events and conditions that are significant to the financial statements
  This refers to capturing of all that information which needs to be disclosed as part of financial statement as a result of compliance to any applicable law. Every information which is required to be disclosed as a matter of statutory compliance should be captured properly.
- The ***financial reporting process*** used to prepare the entity's financial statements.
  This refers to the process of preparing the financial statements from the books of accounts is strong and effective to ensure that there is no possibility of errors. This is a control at the last step i.e., the step at which financial statements are prepared. For example, how information from branches is incorporated in the financial statements.
- ***Controls surrounding journal entries***
  The primary mode of recording a transaction is journal entry. Thus, from journal entry, any transaction will reach the financial statements. Thus, the auditor has to understand all the controls at the point of recording journal entries to ensure they are
  - Recorded by authorized persons
  - Recorded in proper manner
  - Verified by a senior
  - Approved by a senior.

▪ Control activities

- An auditor requires an understanding of only those ***control activities related to significant class of transactions, account balance, and disclosure in the financial statements*** and the assertions which

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he finds relevant in his risk assessment process.

- Control activities are those ***policies and procedures*** laid by the management to ensure that significant transactions are accounted properly.
- Control activities, whether within IT or manual systems, have various objectives and are ***applied at various organizational and functional levels***.
- Thus, control activities relevant to audit are:
  - Control activities that relate to significant risks and those that relate to ***risks for which substantive procedures alone do not provide sufficient appropriate audit evidence*** or
  - Those that are considered to be ***relevant in the judgment of the auditor.***
- Specific control activities for any significant transaction include the following:

Physical controls	One will initiate the transaction; one will verify it and a concerned authority will approve it.
Segregation of duties	The record keeping function and the custodian function should not be with the same person.
Authorization	The safeguarding of physical documents and files.
Performance review	If the processes and procedures are operating effectively
Information processing	How the information is flowing across the organization through these control activities

- **Auditor assessing control risk**
  - When making control risk assessments, the auditor considers:
    - The ***control environment's influence over internal control***. A control environment that supports the prevention, and detection and correction, of material misstatements allows greater confidence in the reliability of internal control and audit evidence generated within the entity.
    - Evaluations of the related ***IT processes that support application*** and IT-dependent manual controls.
    - The ***expectation of the operating effectiveness*** of controls based on the understanding of entity's processes.
  - When auditor identifies deficiencies and reports on internal controls, he determines the significant financial statement assertions that are affected by the ineffective controls.
  - The auditor concludes that they support a ***'rely on controls'*** risk assessment, if he thinks it is appropriate. Otherwise he will change control risk assessment to ***'not rely on controls.'***
  - When control deficiencies are identified and auditor identifies and tests more than one control for each relevant assertion, he evaluates control risk considering all of the controls he has tested.

- **Monitoring of controls**
  - The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting.

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- Monitoring of controls is a process to assess the effectiveness of internal control performance over time. It helps in assessing the effectiveness of controls on a timely basis.
- It involves assessing the effectiveness of controls on a timely basis and taking necessary remedial actions. It includes considering whether controls are operating as intended and that they are modified as appropriate for change in conditions.
- Management accomplishes monitoring of controls through ongoing activities, separate evaluations, or a combination of the two. Ongoing monitoring activities are often built into the normal recurring activities of an entity and include regular management and supervisory activities.
- Management's monitoring activities may include using information from communications from external parties such as customer complaints and regulator comments that may indicate problems or highlight areas in need of improvement

9. Significant risks

- Significant risks are inherent risks with both a higher likelihood of occurrence and a higher magnitude of potential misstatement.
- Significant risks often relate to significant non- routine transactions or judgmental matters.
- Non-routine transactions are transactions that are unusual, due to either size or nature, and that therefore occur infrequently.
- Judgmental matters may include the development of accounting estimates for which there is significant measurement uncertainty.
- Risks of material misstatement may be greater for significant non-routine transactions arising from matters such as the following:
  - Greater management intervention to specify the accounting treatment.
  - Greater manual intervention for data collection and processing.
  - Complex calculations or accounting principles.
  - The nature of non-routine transactions, which may make it difficult for the entity to implement effective controls over the risks.
- Risks of material misstatement may be greater for significant judgmental matters that require the development of accounting estimates, arising from matters such as the following:
  - Accounting principles for accounting estimates or revenue recognition may be subject to differing interpretation.
  - Required judgment may be subjective or complex, or require assumptions about the effects of future events, for example, judgment about fair value.

Risk that require Special Audit consideration

In exercising judgment as to which risks are significant risks, the auditor shall consider at least the following:

- Whether the risk is a ***risk of fraud***
- Whether the risk is related to ***recent*** significant economic, accounting, or other ***developments*** like changes in regulatory environment, etc., and, therefore, requires specific attention
- The ***complexity*** of transactions
- Whether the risk involves significant transactions with ***related parties***
- The ***degree of subjectivity*** in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and

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- Whether the risk involves significant transactions that are ***outside the normal course of business*** for the entity, or that otherwise appear to be unusual.

Evaluation of Internal Control

The auditor needs ***reasonable assurance that the accounting system is adequate*** and that all the accounting information which should be recorded has in fact been recorded. Internal control normally contributes to such assurance.
Thus, the examination and evaluation of the internal control system is an indispensable part of the overall audit programme.

Benefits of Evaluation of Internal Control:

- whether errors and frauds are likely to be located in the ordinary course of operations of the business.
- whether an internal control system is in use, is it adequate and operating as planned by the management.
- whether an effective internal auditing department is operating.
- whether the controls adequately safeguard the assets.
- how far and how adequately the management is discharging its function in so far as correct recording of transactions is concerned.
- how reliable the reports, records and the certificates to the management can be.
- the extent and the depth of the examination that he needs to carry out in the different areas of accounting.
- what would be appropriate audit technique and the audit procedure in the given circumstances.
- what are the areas where control is weak and where it is excessive
- whether some worthwhile suggestions can be given to improve the control system.

Internal Control = Internal check + Internal Audit

10. Formulating Audit Programme

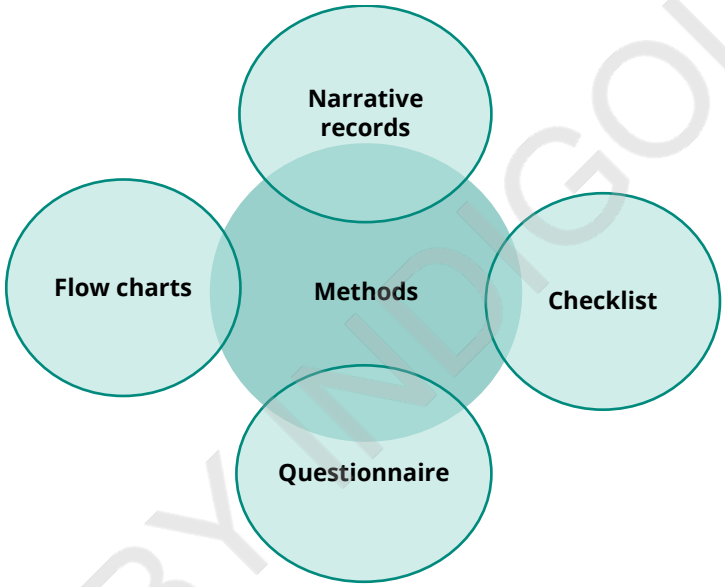
- The auditor can formulate his entire audit programme only after he has had a satisfactory understanding of the internal control systems and their actual operation. If he does not care to study this aspect, it is very likely that his audit programme may become unwieldy and unnecessarily heavy and the object of the audit may be altogether lost in the mass of entries and vouchers
- It is also important for him to know whether the system is actually in operation. Often, after installation of a system, no proper follow up is there by the management to ensure compliance. The auditor, in such circumstances, may be led to believe that a system is in operation which in reality may not be altogether in operation or may at best operate only partially.
- the extent and the nature of the audit programme is substantially influenced by the internal control system in operation.
- A proper understanding of the internal control system in its content and working also enables an auditor to decide upon the appropriate audit procedure to be applied in different areas to be covered in the audit programme.
- In a situation where the internal controls are considered weak in some areas, the auditor might choose an auditing procedure or test that otherwise might not be required; he might extend certain tests to cover a large number of transactions or other items than he otherwise would examine and at times he may perform additional tests to bring him the necessary

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satisfaction.

11. Methods to evaluate the internal controls

- A review of the internal control can be done by a ***process of study, examination and evaluation of the control system*** installed by the management.
- The first step involves determination of the control and procedures laid down by the management.
- By reading company manuals, studying organisation charts and flow charts and by making suitable enquiries from the officers and employees, the auditor may ascertain the character, scope and efficacy of the control system.
- In many cases, very little information is available in writing; the auditor must ask the right people the right questions if he is to get the information he wants.
- It would be better if he makes written notes of the relevant information and procedures contained in the manual or ascertained on enquiry.
- To facilitate the accumulation of the information necessary for the proper review and evaluation of internal controls, the auditor can use one of the following tools.



▪ Narrative Record

- This is a ***complete and exhaustive description of the system*** as found in operation by the auditor.
- ***Actual testing and observation are necessary*** before such a record can be developed.
- It may be recommended in cases where no formal control system is in operation and would be ***more suited to small business.***
- The ***basic disadvantages*** of narrative records are:
  - The system in operation is quite ***difficult to comprehend***.
  - To ***identify weaknesses*** or gaps in the system.
  - To ***incorporate changes*** arising on account of reshuffling of manpower, etc.

▪ Check List

- This is a ***series of instructions and/or questions which a member of the auditing staff must follow and/or answer***.
- When he completes instruction, he initials the space against the instruction.
- Answers to the check list instructions are usually ***Yes, No or Not Applicable***.

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- This is again an ***on the job requirement*** and instructions are framed having regard to the desirable elements of control.
- The complete check list is ***studied by the Principal***/Manager/Senior to ascertain existence of internal control and evaluate its implementation and efficiency.

A few examples of check list instructions are given hereunder:

- Are tenders called before placing orders?
- Are the purchases made on the basis of a written order?
- Is the purchase order form standardised?
- Are purchase order forms pre-numbered?
- Are the inventory control accounts maintained by persons who have nothing to do with custody of work, receipt of inventory, inspection of inventory and purchase of inventory?

Internal Control Questionnaire

- This is a ***comprehensive series of questions*** concerning internal control.
- This is the ***most widely used form*** for collecting information about the existence, operation, and efficiency of internal control in an organization.
- An important advantage of the questionnaire approach is that ***oversight*** or omission of significant internal control review procedures is ***less likely to occur*** with this method.
- With a proper questionnaire, all internal control evaluation can be ***completed at one time*** or in sections.
- The ***review*** can more easily be made on an ***interim basis.***
- In the questionnaire, generally questions are so framed that a ***'Yes' answer denotes satisfactory position*** and a ***'No' answer suggests weakness.*** Provision is made for an explanation or further details of 'No' answers. In respect of questions ***not relevant to the business, 'Not Applicable'*** reply is given.
- The questionnaire is usually issued to the client and the client is requested to get it ***filled by the concerned executives and employees.***
- If on a perusal of the answers, inconsistencies are noticed, the matter is further discussed by auditor's staff with the client's employees for a clear picture.
- The concerned auditor then prepares a report of deficiencies and recommendations for improvement.

Examples of Extracts of Internal Control Questionnaire in respect of purchases, and fixed assets

A. Purchases

(1) Are purchases centralised in the Purchase Department?
(2) (a) Are purchases made only from approved suppliers?
(b) Is a list of approved suppliers maintained for this purpose?
(c) Does the master list contain more than one source of supply for all important materials?
(3) Are the purchase orders based on valid purchase requisitions duly signed by authorised persons in this behalf?
(4) Are purchases based on competitive quotations from two or more suppliers?
(5) Are purchase orders pre-numbered?
(6) Are purchase orders signed only by employees authorized in this behalf?
(7) Are all materials received only in the Receiving Department?

B. Fixed Assets

(1) Are budgets for capital expenditure approved?

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(2) Is the authority to incur capital expenditure restricted to specified officials?
(3) Are purchases of capital expenditure subject to same controls as applicable to purchases of raw materials, stores etc.?
(4) Is there proper check to see that amounts expended do not exceed the amount authorized?
(5) Are fixed assets verified periodically?
(6) Is there a written procedure for such verification?
(7) Are reports prepared on such verification?
(8) Do such reports indicate damaged/obsolete items of fixed assets?
(9) Are discrepancies disclosed by such reports investigated?
(10) Are the records and financial accounts corrected with appropriate authority?

- **A Flow Chart**

- It is a ***graphic presentation*** of each part of the company's system of internal control.
- A flow chart is considered to be the ***most concise way of recording*** the auditor's review of the system.
- It ***minimizes the amount of narrative explanation*** and thereby achieves a consideration or presentation not possible in any other form.
- It gives ***bird's eye view*** of the system and the flow of transactions and integration and in documentation, can be easily spotted and improvements can be suggested.
- It is also necessary for the auditor to study the significant features of the business carried on by the concern, the nature of its activities and various channels of goods and materials as well as cash, both inward and outward and also a comprehensive study of the entire process of manufacturing, trading and administration. This will help him to understand and evaluate the internal controls in the correct perspective.

Best tool – Each tool has its share of advantages and disadvantages so the auditor has to use his profession judgement to decide which tool can be used based on the requirement of information.

11.1 Testing of controls

- After assimilating the internal control system, the auditor needs to examine ***whether and how far the same is actually in operation***.
- For this, he resorts to actual testing of the system in operation. This is done on a selective basis.
- He can plan this testing in such a manner that all the important areas are covered in a period of, say, three years. Selective testing is done by application of procedural tests and auditing in depth.
- Test of controls are performed to obtain audit evidence about the effectiveness of the
  - Design of the accounting and internal control system i.e., Whether they are designed to prevent, detect, and correct material misstatements. And
  - Operation of internal controls throughout the period.
- Some of the procedures performed to obtain the understanding of the accounting and internal control systems may not have been specifically planned as tests of control but may provide audit evidence about the effectiveness of the design and operation of internal controls relevant to certain assertions.
- Test of controls may include:
  - ***Inspection of documents*** supporting transactions and other events.
  - ***Inquiries*** about, and ***observation*** of, internal controls which leave no audit trail, for example, determining who actually performs each function and not merely who is supposed to perform

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it.

- ***Re-performance*** involves the auditor's independent execution of procedures or controls for example, reconciliation of bank accounts, to ensure they were correctly performed by the entity.
- Testing of internal control operating on ***specific computerized applications*** or over the overall information technology function, for example, access or program change.

Automated Environment

Meaning of Automated Environment

- A business environment where the processes, operations, accounting and even decisions are carried out by using computer systems – also known as Information Systems (IS) or Information Technology (IT) systems. Nowadays, it is very common to see computer systems being used in almost every type of business.
- The fundamental principle of an automated environment is the ability to carry out business with less manual intervention and more system driven. The complexity of a business environment depends on the level of automation i.e., if a business environment is more automated, it is likely to be more complex

Key features of Automated Environment

- Enables faster business operation
- Accuracy in data processing and computation
- Ability to process large volume of transactions
- Integration amongst business operations
- Better security and controls
- Less prone to human errors Provides latest information
- Connectivity and networking capability

Understanding and Documenting Automated Environment

Auditor should consider to obtain an understanding of the company's automated environment in following matter

- Information systems being used (one or more application systems and what they are)
- Their purpose (financial and non-financial)
- Location of IT systems - local vs global
- Architecture (desktop based, client-server, web application, cloud based)
- Version (functions and risks could vary in different versions of same application).
- Interfaces within systems (in case multiple systems exist).
- In-house vs Packaged.
- Outsourced activities (IT maintenance and support).
- Key persons (CIO, CISO, Administrators).

The understanding of a company's IT environment that is obtained should be documented.

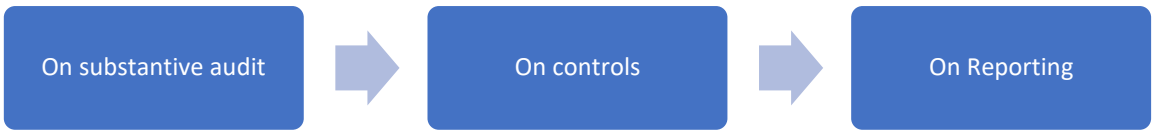
Risks arising from use of IT Systems

- Inaccurate processing of data, processing inaccurate data, or both.
- Unauthorized access to data.
- Direct data changes (backend changes).
- Excessive access / Privileged access (super users).
- Lack of adequate segregation of duties.
- Unauthorized changes to systems or programs.
- Failure to make necessary changes to systems or programs.

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- Loss of data.

Impact of IT related risks



Impact on substantive checking

- Inability to address above discussed risks may lead to non-reliance of data obtained from systems.
- In such a case, all information, data, and reports would have to be tested thoroughly for their completeness and accuracy.
- It could lead to increased substantive checking i.e., detailed checking.

Impact on controls

- It can lead to non-reliance on automated controls, system calculations and accounting procedures built into applications.
- It may result in additional audit work.

Impact on reporting

- Due to regulatory requirements in respect of internal financial controls in case of companies, it may lead to modification of auditor's report in some instances.

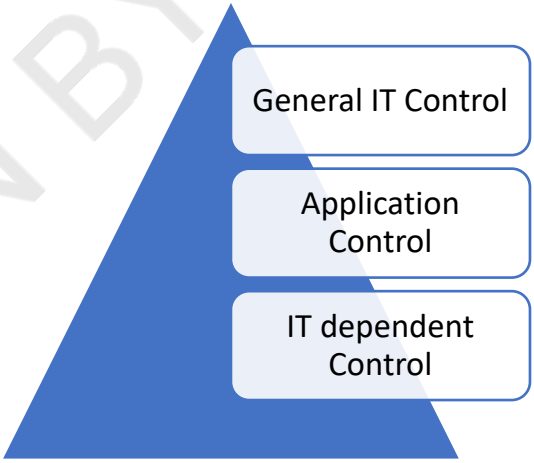
12. Types of Controls in an automated environment

Controls in an automated environment can be categorized as under: -

(A) General IT controls

(B) Application controls

(C) IT-dependent controls



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General IT Control

General IT controls are policies and procedures that relate to many applications and support the effective functioning of application controls. General IT-controls that maintain the integrity of information and security of data commonly include controls over the following:

- Data centre and network operations
- Program change
- Access security
- Application system acquisition, development, and maintenance (Business Applications)

These are IT controls generally implemented to mitigate the IT specific risks and applied commonly across multiple IT systems, applications and business processes. Hence, General IT controls are known as "pervasive" controls or "indirect" controls.

(a)Controls over Data centre and network operations

- The objective of controls over Data centre and network operations is to ensure that production systems are processed to meet financial reporting objectives.
- These include activities such as
    - overall management of computer operation activities,
    - preparing, scheduling and executing of batch jobs,
    - monitoring, storage and retention of backups.
    - Such controls also help in performance monitoring of operating system, database and networks.
    - Matters such as BCP (Business continuity plan) and DRP (Disaster recovery plan) which deal with recovery from failures are also taken care of by such type of controls.

(b)Program Change

- The objective of program change controls is to ensure that modified systems continue to meet financial reporting objectives.
- It includes activities such as
    - change management process,
    - recording, managing and tracking change requests,
    - making and testing changes etc.

(c)Access Security

- The objective of controls over access security is to ensure that access to programs and data is authenticated and authorized to meet financial reporting objectives.
- It includes activities such as
    - security organization & management,
    - security policies & procedures,
    - application security,
    - data security,
    - operating system security,
    - network security,
    - physical security etc.

(d)Application system acquisition, development, and maintenance

- The objective of such controls is to ensure that systems are developed, configured and implemented to meet financial reporting objectives.
- It includes
    - overall management of development activities,
    - project initiation,
    - analysis & design,
    - construction,
    - testing & quality assurance etc

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Application Controls

1. Application controls include both automated or manual controls that operate at a business process level.
2. Automated Application controls are embedded into IT applications viz., ERPs and help in ensuring the completeness, accuracy and integrity of data in those systems.
3. Examples of automated applications include
    a. edit checks and validation of input data,
    b. sequence number checks,
    c. user limit checks,
    d. reasonableness checks,
    e. mandatory data fields.

IT dependent Controls

- IT dependent controls are basically manual controls that make use of some form of data or information or report produced from IT systems and applications.
- Though the control is performed manually, the design and effectiveness of such controls depends on the reliability of source data.
- Due to the inherent dependency on IT, the effectiveness and reliability of automated application controls and IT dependent controls require the General IT controls to be effective.

General IT Controls vs. Application Controls

- These two categories of control over IT systems are interrelated.
- The relationship between the application controls and the General IT Controls is such that General IT Controls are needed to support the functioning of application controls, and both are needed to ensure complete and accurate information processing through IT systems.

13. Testing methods in an automated environment

- There are basically four types of audit tests that should be used.
- These are ***inquiry, observation, inspection and reperformance***.
- ***Inquiry is the most efficient*** audit test but it also gives the least audit evidence. Hence, inquiry should always be used in combination with any one of the other audit testing methods. Inquiry alone is not sufficient.
- ***Reperformance is most effective*** as an audit test and gives the best audit evidence. However, testing by reperformance could be very time consuming and least efficient most of the time.
- Applying ***inquiry in combination with inspection*** gives the most effective and efficient audit evidence.
- The auditor should ***document the nature of test*** (or combination of tests) applied along with the judgements in the audit file.
- When testing in an automated environment, some of the ***more common methods are as follows:***
    - Obtain an understanding of how an automated transaction is processed by doing a walkthrough of one end-to-end transaction using a combination of inquiry, observation and inspection.
    - Observe how a user processes transactions under different scenarios.
    - Inspect the configuration defined in an application.

14. CHARACTERISTICS OF MANUAL AND AUTOMATED ELEMENTS OF INTERNAL CONTROL RELEVANT TO THE AUDITOR'S RISK ASSESSMENT

- An entity's system of internal control contains manual elements and often contains automated elements. The characteristics of manual or automated elements are relevant to the auditor's risk assessment and further audit procedures based thereon. The use of manual or automated elements in internal control also affects the manner in which transactions are initiated, recorded, processed, and reported:
    - Controls in a manual system may include such procedures as approvals and reviews of transactions,

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and reconciliations and follow-up of reconciling items. Alternatively, an entity may use automated procedures to initiate, record, process, and report transactions, in which case records in electronic format replace paper documents.

- Controls in IT systems consist of a combination of automated controls (for example, controls embedded in computer programs) and manual controls.
- Further, manual controls may be independent of IT, may use information produced by IT, or may be limited to monitoring the effective functioning of IT and of automated controls, and to handling exceptions

15. Manual elements vs automated elements in entity's internal control

Manual elements in internal control may be more suitable where judgment and discretion are required such as for the following circumstances

- Large, unusual or non-recurring transactions.
- Circumstances where errors are difficult to define, anticipate or predict.
- In changing circumstances that require a control response outside the scope of an existing automated control.
- In monitoring the effectiveness of automated controls.

Manual elements in internal control may be less reliable than automated elements in circumstances like

- High volume or recurring transactions, or in situations where errors that can be anticipated or predicted can be prevented, or detected and corrected, by control parameters that are automated.
- Control activities where the specific ways to perform the control can be adequately designed and automated.

16. AUDIT APPROACH IN AN AUTOMATED ENVIRONMENT



- **Risk Assessment:**
  - Identify significant accounts and disclosures
  - Qualitative and Quantitative characteristics
  - Relevant FS Assertions
  - Identify likely sources of Misstatements and
  - Consider Risk arising from use of IT systems
- **Understand and Evaluate:**
  - Document understanding of business process using flowcharts/Narratives
  - Prepare risk and control matrices (RCM)
  - Understand design of controls by performing walkthroughs of end-to end process
  - Process wide considerations for entity level controls, Segregation of duties and
  - IT general controls and Application Controls
- **Test for operating effectiveness**
  - Assess NTE of control testing
  - Assess reliability of source data and completeness of population
  - Testing of key reports and spreadsheets
  - Sample testing and
  - Consider competence and independence of staff/ team performing control testing.

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- **Reporting**
  - Evaluate control deficiencies
  - Significant deficiencies and material weaknesses
  - Reconciliation of Control weaknesses
  - Internal control memo (ICM) of Management Letter and
  - Auditors Report

17. Data Anaytics

- The amount of data and information that exists in these systems is enormous.
- The combination of processes, tools and techniques that are used to tap vast amounts of electronic data to obtain meaningful information is called data analytics.
- The tools and techniques that auditors use in applying the principles of data analytics are known as Computer Assisted Auditing Techniques or CAATs in short. Data analytics can be used in testing of electronic records and data residing in IT systems using spreadsheets and specialised audit tools viz., IDEA and ACL to perform the following
  - Check completeness of data and population that is used in either test of controls or substantive audit tests.
  - Selection of audit samples – random sampling, systematic sampling.
  - Re-computation of balances – reconstruction of trial balance from transaction data.
  - Reperformance of mathematical calculations – depreciation, bank interest calculation.
  - Analysis of journal entries
  - Fraud investigation.
  - Evaluating impact of control deficiencies.

Digital Audit

- Entities are embracing digitization as part of their operations to keep pace with changing times. New technologies are helping companies revamp their operations and rethink the way business is conducted. Companies are restructuring their business models driven by technology. Automation is key to digitization.
- In such a business environment, use of digital technology is being made by auditors right from planning to expression of final opinion.
- Auditors are making use of artificial intelligence, data analytics and other latest technologies to help understand business processes in a better way. By using such tools, auditors can conduct audit in a better way and devote more attention to areas requiring greater focus.
- Digital audit is helping auditors to better identify risks making use of technology.

18. Internal Financial Control & Reporting

Meaning of Internal Financial controls

Internal Financial Controls (IFC) basically refers to the policies and procedures put in place by companies for ensuring

- Reliability of financial reporting
- Effectiveness and efficiency of operations
- Compliance with applicable laws and regulations
- Safeguarding of assets
- Prevention and detection of frauds

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Reporting Requirements	
Sec 134(5)(e)	**In case of listed Companies, the Directors' responsibility statement shall state that the Directors had laid down Internal financial controls to be followed by the company and that such Internal financial controls are adequate and were operating effectively**
Section 143(3)(i) of the Act	**The auditor's report shall state whether the company has adequate Internal financial controls system in place and also on the operating effectiveness of such controls.** **This requirement shall not apply to a private company which –** **(i) is One Person Company or a small company; or** **(ii) has turnover less than ₹ 50 crore as per latest audited Financial Statements; and which has aggregate borrowings from banks or financial institutions or any body corporate at any point of time during the financial Year for less than ₹ 25 crore.**
Section 177(4)(vii) of the Act	**Every audit Committee shall act in accordance with the terms of reference specified in writing by the Board which shall, inter alia, include - evaluation of internal financial controls and risk management systems**
As per Section 149(8) of the Act	**The company and independent directors shall abide by the provisions specified in Schedule IV which lays down the Code for independent Directors. As per this code, the role and functions of independent directors include that they shall satisfy themselves on the integrity of financial information and that financial controls and the systems of risk management are robust and defensible.**

19. DOCUMENTING THE RISKS

The auditor shall document:

(a) The discussion among the engagement team and the significant decisions reached

(b) Key elements of the understanding obtained regarding each of the aspects of the entity and its environment and of each of the internal control components, the sources of information from which the understanding was obtained; and the risk assessment procedures performed

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(c) The identified and assessed risks of material misstatement at the financial statement level and at the assertion level and

(d) The risks identified, and related controls about which the auditor has obtained an understanding.

20. ASSESS AND REPORT AUDIT FINDINGS

- At the conclusion of each audit, it is possible that there will be certain findings or exceptions in IT environment and IT controls of the company that need to be assessed and reported to relevant stakeholders including management and those charged with governance viz., Board of directors, Audit committee .

Consideration while assessing the findings

- Are there any weaknesses in IT controls?
- What is the impact of these weaknesses on overall audit?
- Report deficiencies to management – Internal controls memo or Management letter.
- Communicate in writing any significant deficiencies to those Charged with governance.
- The auditor needs to assess each finding or exception to determine impact on the audit and evaluate if the exception results in a deficiency in internal control.

- A deficiency in internal control exists if a control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis; or the control is missing.
- Evaluation and assessment of audit findings and control deficiencies involves applying professional judgement that include considerations for quantitative and qualitative measures.
- Each finding should be looked at individually and in the aggregate by combining with other findings/deficiencies.

SA 330 - The Auditor's Responses to Assessed Risks

Contents

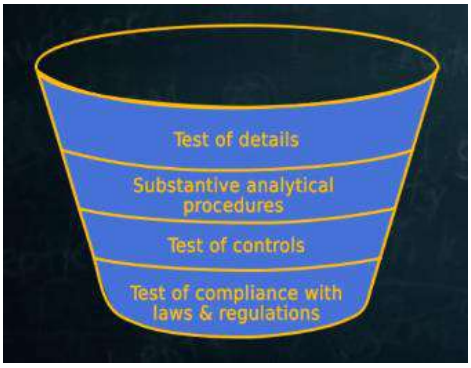
- Auditor's response
- Test of Controls
- Substantive Procedures

Auditor's objective

Obtain sufficient appropriate audit evidence about the assessed risks of material misstatement and accordingly, design and implement appropriate responses to those risks.

Audit steps to achieve such objective can be broadly classified into

- Compliance Procedures
  - Test of compliance with laws and regulations
  - Test of controls
- Substantive Procedures
  - Test of details
  - Substantive analytical procedures



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20.1 Important Terms

SA 315 – Identify risks
SA 330 – How the auditor should respond to such risks

20.1.1 Substantive Procedure

An audit procedure designed to detect material misstatement at the assertion level. These comprise:

- Tests of details (e.g. vouching and verification)
- Substantive analytical procedures.

20.1.2 Test of Controls

An audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting material misstatements at the assertion level.

20.2 Auditor's Overall Responses

Auditor shall design and implement overall responses to address the assessed risk of material misstatement at financial statement level. Auditor shall design further audit procedures which depend on the overall responsiveness to the assessed risks.

An overall response includes:

- Ensuring high degree of professional skepticism amongst audit team members
- Assigning more experienced staff or those with special skills or using experts
- Providing more supervision
- Incorporating element of surprise into the audit.
- Making suitable changes to nature, timing and extent of audit procedures.
- Emphasis on substantive procedures or may use tests of controls as well as substantive procedures.

20.2.1 Audit procedures responsive to the assessed risks of material misstatement at the assertion level

- To address the assessed risk of material misstatement at the financial statement level, the auditor should design overall responses such as providing more supervision, assigning more experienced/ skilled staff, etc.
- The auditor shall consider the reasons for the assessment given to a risk including the related inherent risk and control risk.
- Higher the assessment of risk, more persuasive audit evidence should be obtained.

20.3 Test of Controls

A test of controls is an audit procedure to test the effectiveness of a control used by a client entity to prevent or detect material misstatements.

Depending on the results of this test, auditors may choose to rely upon a client's system of controls as part of their auditing activities. However, if the test reveals that controls are weak, the auditors will enhance their use of substantive testing, which usually increases the cost of an audit.

20.3.1 Application

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The auditor shall design and perform test of controls to obtain sufficient appropriate audit evidence only when:

- controls are effective; or
- Substantive procedures and tests of controls are to be used together.

The auditor may design tests of control to be performed concurrently with test of details on same transaction.

20.3.2 Nature & extent

- The auditor shall use other audit procedures such as
  - inspection or
  - performance (how, by whom, consistency) in combination with
  - inquiry

  to obtain audit evidence or to test about the operating effectiveness of controls.
- If the auditor needs more persuasive audit evidence, he may increase the extent of tests of control.
- Determine whether the controls to be tested depend upon other controls and if so, the auditor should test the operating effectiveness of these indirect controls.

20.3.3 Timing

The auditor shall test controls pertaining only to a point in time or over a period of time.
The objective is to provide an appropriate basis for the reliance auditor needs to place on the internal control.

The timing for test of controls also depends on usage of audit evidence obtained about operating effectiveness of controls during the interim period or from previous audit

20.3.4 Using audit evidence obtained during an interim period

Obtain audit evidence about significant changes to those controls subsequent to interim period.
Determine additional evidence to be obtained for the remaining period

20.3.5 Using audit evidence obtained in previous audit about

- **Controls in general**

The auditor may increase or decrease the expected audit evidence to be obtained in current period about the operating effectiveness of the controls after considering

- the effectiveness of other elements of internal control, including the control environment, the entity's monitoring of controls, and the entity's risk assessment process;
- Risk from controls depending on automation of the control
- The effectiveness of general IT-controls;
- The effectiveness of the control and its application by the entity, including the nature and extent of deviations in the application of the control noted in previous audits, and whether there have been personnel changes that significantly affect the application of the control;
- Whether the lack of a change in a particular control poses a risk due to changing circumstances; and
- The risks of material misstatement and the extent of reliance on the control

- **Specific Controls**

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The auditor has to check the continuing relevance of the evidence by obtaining further evidence considering the significant changes occurred since previous audit. The procedure followed to obtain such further evidence may include:

- If there are any changes, test the controls in the current audit
- If there are no changes, test controls at least once in every third audit and shall test some controls in each audit

When the auditor plans to rely on controls over a risk the auditor has determined to be a **significant risk**, the auditor shall test those controls in the **current period.**

20.3.6 Evaluating operating effectiveness of controls

- **If misstatements detected by substantive procedures**
  - If the auditor has detected a material misstatement, it may indicate the existence of a material weakness in operating effectiveness of controls.
  - He should communicate such material weaknesses in internal control identified during the audit on a timely basis to appropriate level of management.

No misstatements detected by substantive procedures does not mean that controls related to the assertion being tested are effective.

- **If deviations from controls detected**

Auditor shall make specific inquiries to understand potential consequences and shall ensure

- Effectiveness of test of controls to provide evidence to rely on controls
- Additional tests required
- Potential misstatements are addressed using substantive procedures.

20.4 Substantive Procedures

Irrespective of the assessed risk of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance and disclosure.

The auditor shall consider whether external confirmation procedures are to be performed as substantive audit. procedures.

20.4.1 Substantive procedures related to financial statements closing process

- Auditor shall agree or reconcile the financial statements with the underlying accounting records
- Auditor shall examine material journal entries and other adjustments made during the course of preparing financial statements

20.4.2 Substantive procedures responsive to significant risks

When auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, perform substantive procedures that are specifically responsive to that risk, such procedures shall also contain test of details.

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20.4.3 Timing of substantive procedures

When substantive procedures are performed at an interim date, he shall cover the remaining period.

20.4.4 Evaluating the sufficiency and appropriateness of audit evidence

- The assessment of the risks of material misstatement at the assertion level remain appropriate
- sufficient appropriate audit evidence has been obtained
- sufficient appropriate audit evidence is not obtained, he shall express a qualified opinion or a disclaimer of opinion or a disclaimer of opinion

20.4.5 Conclusion

The auditor has to ascertain whether sufficient appropriate audit evidence has been obtained, if not express qualified / disclaimer.

20.5 Documentation

The auditor shall document:

- Overall responses to address the assessed risks of material misstatement at financial statement level;
- Nature, timing and extent of audit procedures performed at the financial statement level and at the assertion level;
- Results of audit procedures and whether financial statements agree or reconcile with the underlying accounting records and audit evidence about the operating effectiveness of controls obtained in previous audit, if relying upon

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CHAPTER 12 - SA 520 Analytical Procedures

Contents

- Analytical Procedures
- Benefits and types of Analytical Procedures
- Methods of Analytical Procedures
- Steps to be followed
- Timing and Purpose

1.1 Auditor's Objective

To design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.

1.2 Analytical Procedures

Analytical procedures are part of substantial analytical procedures. It consists of evaluations of financial information made by a study of relationships among both financial and non-financial data.

It also includes investigation into fluctuations from predicted amounts and into relationships that are

Analytical procedures as per SA 520 means the analysis of significant ratios and trends.

inconsistent with other relevant information.

Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications.

Analytical procedures consider two methods

- comparison of financial data (with prior period, with budgets, with industry benchmarks)
- study relationships of financial information (among other elements of financial statements or with relevant non-financial information)

1.3 Benefits of Analytical Procedures

- To assist the auditor in planning the nature, timing and extent of audit procedures.
- As a substantive procedure when their use can be more effective or efficient than tests of details in reducing detection risk for specific F.S. assertions; and
- As an overall review of the F.S. in the final review, stage of the audit."

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1.4 Auditor's Responsibilities

- Determine the suitability of particular substantive analytical procedures for given assertions, taking account of the assessed risks of material misstatement and tests of details, if any, for these assertions
- Evaluate the reliability of data from which the auditor's expectation of recorded amounts or ratios is developed
- Develop an expectation of recorded amounts or ratios and
- Evaluate whether the expectation is sufficiently precise to identify a misstatement
- Determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation

The auditor shall design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion.

1.5 Factors that affect the reliability of data on which analytical procedures are to be performed

1.5.1 Sources of information

Information may be more reliable when it is obtained from independent sources outside the entity.

1.5.2 Comparability of the information available

Bench mark data from industry or competitors may need to be supplemented to be comparable to that of an entity that produces or provides services and sells specialised products.

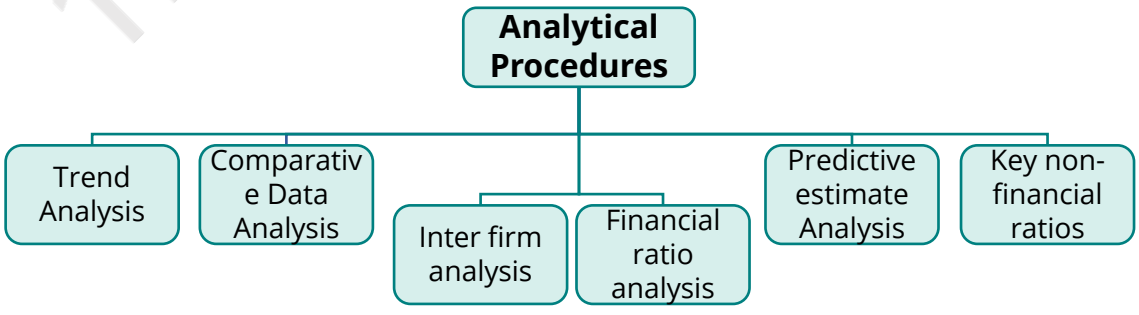
1.5.3 Nature and relevance of the information available

Budgets when are results expected are relevant for analysis but they are unrealistic projections then such data cannot be used.

1.5.4 Controls over the preparation of the information

Controls over the preparation of information are designed to ensure its completeness, accuracy and validity, only then can such information be used for analytical procedures.

1.6 Types of Analytical Procedures



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1.6.1 Trend Analysis

Comparison of the entity's financial information with prior periods.

1.6.2 Comparative Data Analysis

Comparisons of entity's financial information with anticipated results, such as budgets or forecasts.

1.6.3 Predictive Estimate Analysis

Relationship with predictive estimates prepared by the auditor, such as an estimation of depreciation charge for the year.

1.6.4 Inter-Firm Analysis

Comparison of key financial ratios of the entity with other firms of similar size in the industry and/ or with the overall industry average.

1.6.5 Financial Ratio Analysis

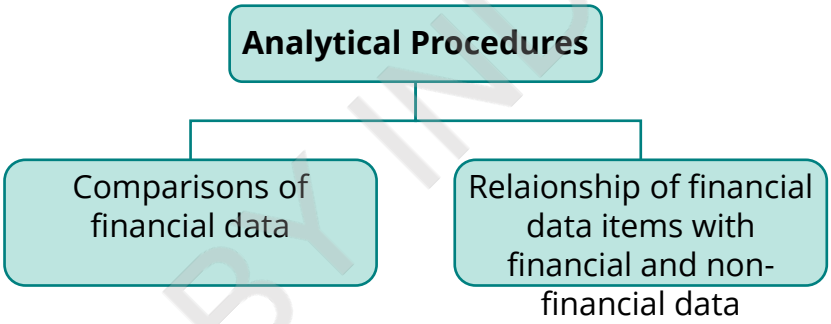
Relationships among elements of financial information e.g. Gross profits, Turnover ratios etc.,

1.6.6 Key non-financial Ratios

Relationships among elements of financial and relevant non-financial information E.g. Payroll costs to number of employees, Sales per employee etc.

1.7 Nature of Analytical Procedures

Analytical procedures encompass two types of procedures broadly.



1.7.1 Comparison of entity's financial information

- **With similar prior – period date**
  - Example: An inventory turnover ratio might indicate that a particular product line had a turnover of three times for past four years but only two times this year but only two times this year. The change may indicate potential obsolescence or errors in accounting records.

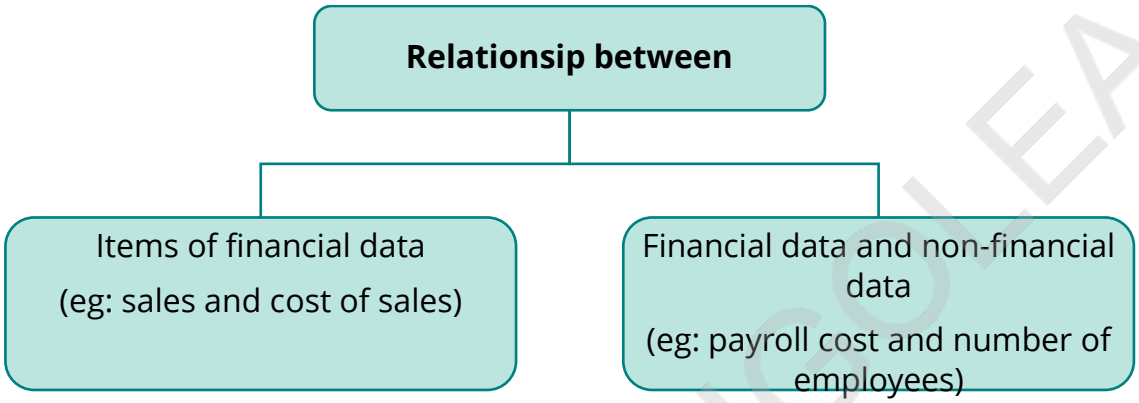
- **With client –determined expected results**
  - Most companies prepare budgets for various aspects of their operations and financial results. Since budgets represent the client's expectations for the period, an investigation the most significant areas in which differences exist between budgeted and actual results may indicate potential misstatements.

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- **With auditor – determined expected results**
  - Example: Moving average of the provision for bad debts as a percent of debtors is applied to the balance of debtors at the end of the audit
  - year to determine an expected value for current allowance by the auditor.

- **With industry data**
  - Industry data provides evidence of how aggregated industry – wise data is affected by conditions in the industry such as declining demand and constrained profit margins.
  - Example: The average collection period for accounts receivable in an industry is 43 days, but the client's average collection period is 65 days. This might indicate problems with product quality or credit risk.

1.7.2 Relationship of financial data items with financial and non-financial data



1.8 Application of Analytical Procedures

The application of analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary.

The presence of these relationships provides audit evidence as to the completeness, accuracy and validity of the data produced by the accounting system.
The procedures can range from simple comparisons to use of sophisticated computer software for advanced statistical techniques such as multiple regression analysis.

1.9 Timing and Purpose of Analytical Procedures

Analytical procedures should be applied at planning stage and the year-end overall review. The auditor may use it at substantive testing phase also.

1.9.1 Planning Phase

- The main purpose to use analytical procedures is to determine the nature, timing and extent of other audit procedures.
- It directs attention to potential risk areas.
  - Example: A decline in gross margin percentage over a period of time may indicate increasing

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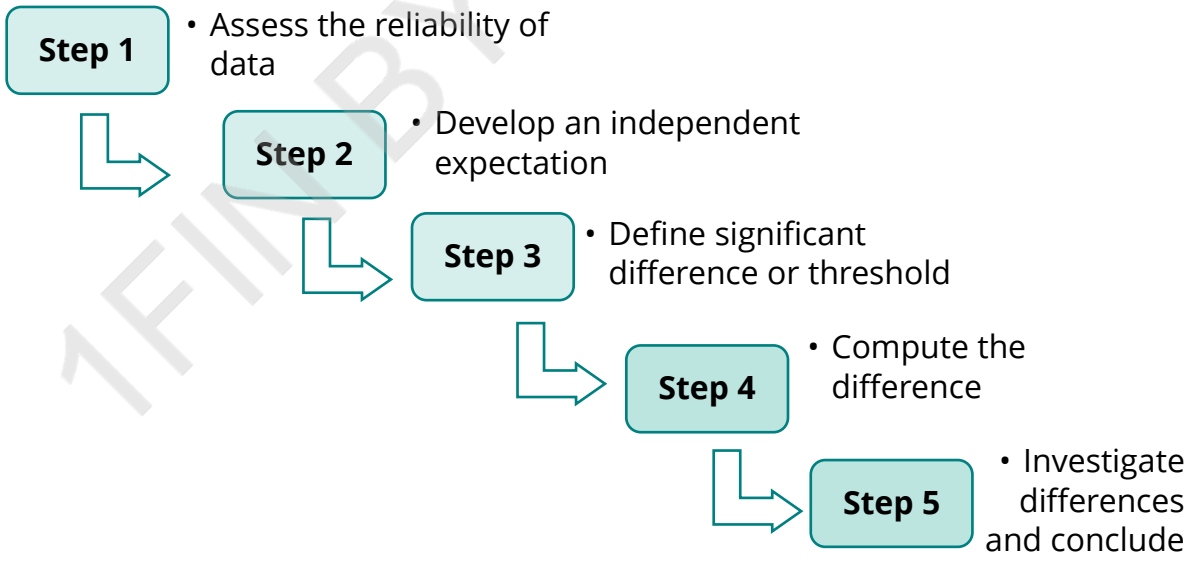
competition in the company's market area and the need to consider inventory pricing during audit.

- It indicates important aspects of business.
  - Example: Operating profit for the business has declined. It may be due to labor problems, industry downturn, dropping of a product line, etc.

1.9.2 Substantive Testing Phase

- When used as substantive tests, the objective of analytical procedures is to accumulate evidence supporting the validity of a specific account balance.
  - Example 1: If average interest rate is applied to average debt outstanding, it provides evidence supporting the amount of interest expense,
- Analytical procedures are used with or without tests of detail to reduce specific detection risk.
  - Example 2: Instead of verifying individual write-offs in a low-risk credit sales system by obtaining direct confirmation (test of detail), an auditor can test provision for bad and doubtful debts by comparing management's estimate to an independent estimate based on prior-year actual and current year sales volume; and write-offs and payment history.
- Level of reliance that an auditor can obtain form analytical review will depend on:
  - Availability, reliability, relevance, independence and comparability of information being used;
  - Nature of the entity and degree to which information can be disaggregated;
  - Adequacy of controls over preparation of information;
  - Risk of non-detection of material misstatements;
  - Materiality of item involved;
  - Extent to which assurance from other sources can be obtained;
  - Accuracy with which figures can be predicated;
  - Assessment inherent and control risks; and
  - Prior knowledge of client and accounting adjustments made in prior periods.

Audit Steps



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1.9.3 Overall Review Phase

- As part of overall review phase, the auditor evaluates the reasonableness of audited financial statements i.e., assertions regarding transactions and balances.
- Knowledge of the client's business combined with effective analytical procedures helps to corroborate the conclusions drawn for individual elements/components of financial statements and in determining sufficiency and appropriateness of audit evidence.
- Example: The auditor has audited inventories. At the overall review stage, he may estimate the closing inventory using historical gross profit rates. If the estimated inventory is nearly the same amount as audited inventory, it would vary, the auditor may have to resolve the reason for disparity.
- Analytical procedures at overall review stage also help to identify possible oversights in an audit and unusual transactions.
  - Example: Sales of the client have decreased in the current period by forty percent. An auditor may expect debtors to decrease by a comparable percent. If this does not happen, it may indicate that sales might have been understated or accounts receivable might be overstated.

1.10 Investigating Results

If analytical procedures performed in accordance with this SA identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences.

1.10.1 Unreasonable or Inconsistent Results

- Inquire with management and consider the need to corroborate management replies through additional procedures such as expanded substantive procedures; and
- Evaluate the reasonableness of management's replies in relation to the auditor's knowledge of the client's business and information obtained during the audit.
- Performing other audit procedures as necessary in the circumstances

1.11 Questions

1) Explain what do you mean by Analytical procedures. How such procedures are helpful in auditing?
2) While auditing purchases which types of analytical procedures will be performed by the auditor to obtain audit evidence as to overall reasonableness of purchase quantity and price. [May 19 (4 Marks)]
3) Discuss the audit procedure to be considered by an auditor while performing analytical procedure to obtain audit evidence as to overall reasonableness of purchase quantity and price. [Nov. 19 (3 Marks)]
4) Routine checks cannot be depended upon to disclose all the mistakes or manipulation that may exist in accounts, certain other procedures also have to be applied like trend and ratio analysis. Analyse and Explain stating clearly the meaning of analytical procedures. [RTP-Nov. 19]
5) Analytical procedures use comparisons and relationships to assess whether account balances or other data appear reasonable. Explain stating the purpose of analytical procedures.

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[RTP-May 18]

6) Give examples of Analytical Procedures having consideration of comparisons of the entity's financial information. [RTP-Nov. 19]
7) Use of substantive Analytical Procedures requires consideration of many factors. Explain those factors.
8) When designing and performing substantive analytical procedures, either alone or in combination with tests of details, as substantive procedures in accordance with SA 330, the auditor shall determine the suitability of particular substantive analytical procedures for given assertions, taking account of the assessed risks of material misstatement and tests of details, if any, for these assertions. Explain the other relevant points in this context. [RTP-May 20]
9) What are the factors that determine the extent of reliance that the auditor places on results of analytical procedures? Explain with reference to SA-520 on "Analytical procedures".

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CHAPTER 13 - SA 530 – Audit Sampling

Contents

- Audit Sampling
- Sampling risk
- Steps in Sampling
- Type of Sampling

1.12 Introduction

Auditor uses statistical and non-statistical sampling as part of the audit procedures during:

- Designing and selecting the audit sample
- Performing tests of controls and tests of details and
- Evaluating the results from the sample

1.12.1 Reason for Sampling

Audit in 70's to 80's meant checking every transaction to get confidence known as Traditional approach. But in the age of real time transaction processing and occurrence of million transactions per second, time is a major constraint to check every transaction.

The concept of Audit sampling was introduced, where less than 100% of the population is tested to get reasonable reliance on the population. Introduction of formal internal controls are being introduced in the management of affairs of organisations, due to which the possibilities of routine errors and frauds have greatly diminished.

It is also not obligatory that the auditor must adopt the sampling technique

The present-day approach for auditing is more of Risk based approach.

1.13 Important Terms

1.13.1 Audit Sampling

Audit sampling is the process of applying audit procedures to less than hundred per cent of a population of audit relevance such that all sample units have a chance of selection, in order to provide the auditor with reasonable basis to draw conclusions about entire population.

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1.13.2 Sampling Risk

Risk that the sample may not be a representative of the population is the

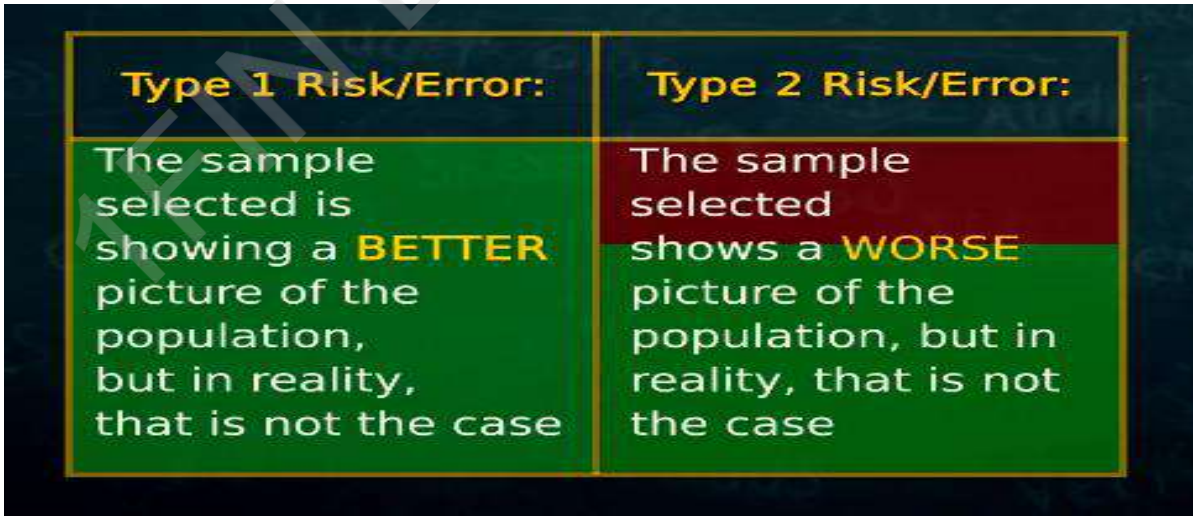
Sampling risk is the risk that auditor's conclusion based on a sample may be different from the conclusion he would reach if the same audit procedures were applied to the entire population.

The lower the risk the auditor is willing to accept, the greater the sample size will need to

Sampling risk can lead to two types of erroneous conclusions:

- In the case of a test of controls, that controls are more effective than they actually are, or in the case of a test of details, that a material misstatement does not exist when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.
- In the case of a test of controls, that controls are less effective than they actually are, or in the case of a test of details, that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.

Error type	In case of test of controls	In case of test of details	Effect of this erroneous conclusion
Type I	That controls are **more effective** than they actually are.	That a material Misstatement **doesn't exist**, when in fact it does	This affects **audit effectiveness**, and is more likely to lead to an inappropriate audit opinion
Type II	That controls are **less effective** than they actually are.	That a material misstatement **does exist**, when in fact it doesn't	This affect **audit efficiency**, as it would lead to additional work to establish that initial conclusions were incorrect



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1.13.3 Sampling Units

Sampling units are individual auditable elements that constitute the population.

1.13.4 Non-Sampling Risk

The risk that auditor reaches an erroneous conclusion for any reason not related to sampling risk.

1.13.5 Statistical Sampling

An approach to sampling that has the following characteristics

- Random selection of the sample items and
- Use of probability theory to evaluate sample results for measurement of sampling risk

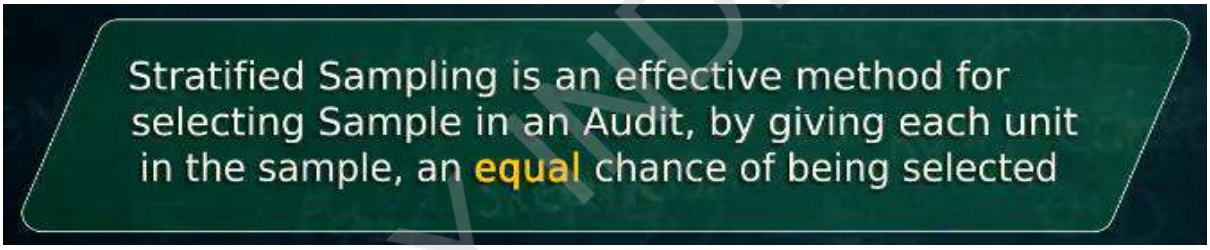
Non-statistical sampling approach does not have characteristics of random selection and use of probability theory.

The expected degree of objectivity cannot be assured in non-statistical sampling because the risk of personal bias in selection of sample items cannot be eliminated

1.13.6 Stratification

The process of dividing a population into sub-populations, each of which is a group of sampling units, which have similar characteristics.

The objective of stratification is to reduce the variability of items within each stratum and therefore allow sample size to be reduced without increasing



Assuming or concluding that the sample selected represents the rest of the population is called Extrapolation.

1.13.7 Tolerable Misstatement

A monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population.

The maximum amount of known error and likely error an auditor can accept in the financial statements without adjustment.

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Objective of determining tolerable misstatement is to address the risk that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated and provide a margin for possible undetected misstatements.

Tolerable misstatement is the application of performance materiality, as defined in SA 3202, to a particular sampling procedure. Tolerable misstatement may be the same amount or an amount lower than performance materiality.

1.13.8 Tolerable Rate of Deviation

A rate of deviation from prescribed internal control procedures set (a threshold) by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the rate of deviation set by the auditor is not exceeded by the actual rate of deviation in the population.

1.13.9 Expected Error vs Tolerable Error

If the deviation rate is higher than this threshold value, then the auditor cannot rely upon the control.

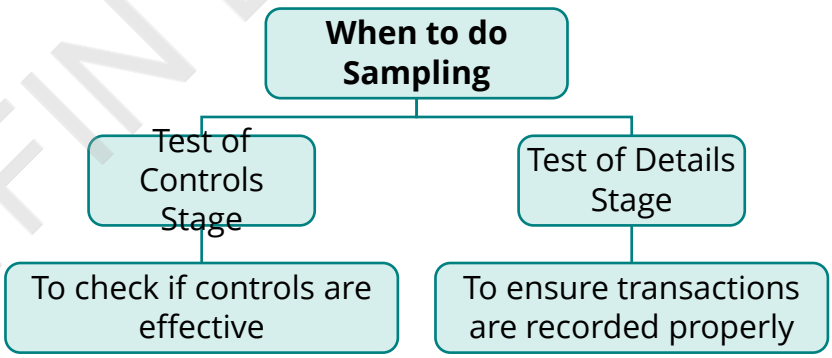
- Expected error is the expected level of deviation, which is ok or acceptable.
- Tolerable Error is the cut-off level beyond which, deviation will not be acceptable.

1.14 Requirements of SA

Auditor shall consider

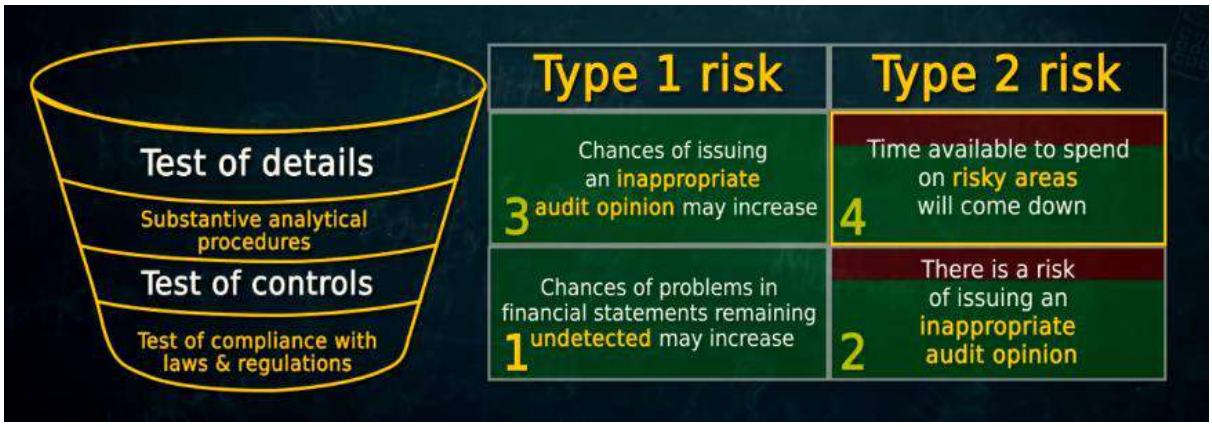
- Auditor while performing audit sampling, shall consider
  - purpose of audit procedure and
  - characteristics of the population from which the sample will be drawn.
- Objective of determining a sample size is to reduce sampling risk to an acceptably low level.
- Auditor shall ensure that each sampling unit in the population has a chance of selection.

1.15 Stage of Audit to do Sampling



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1.15.1 Timing of Sampling and Type of Risk



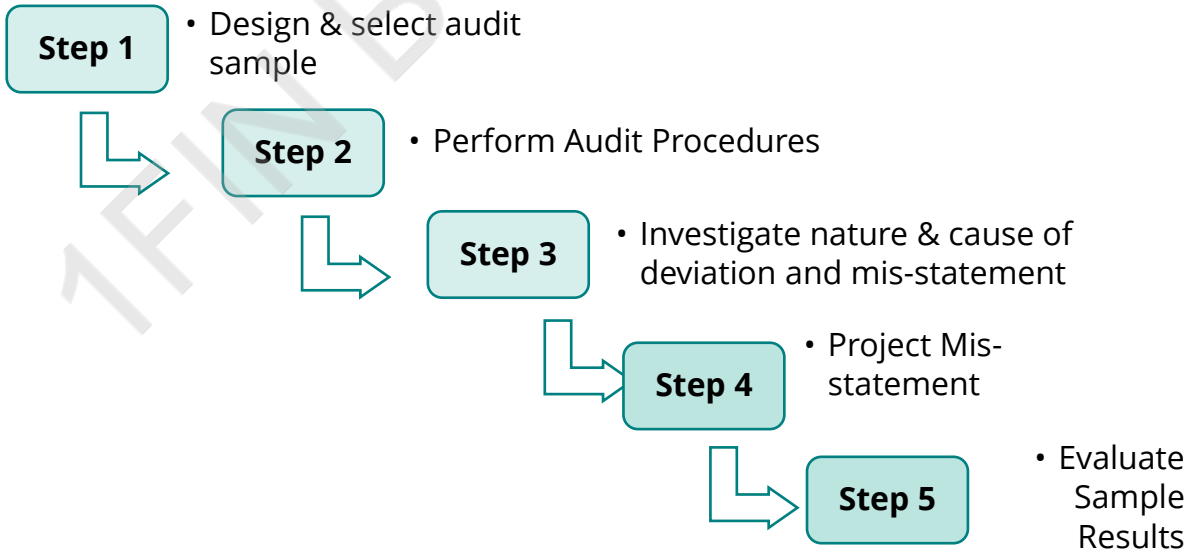
1.16 Targeted Testing vs Sampling

Since the auditor cannot make sampling risk as zero, auditor may take up targeted testing. Targeted testing can be used to test high value transactions and sampling can be used for the rest of the transactions.

1.17 Considerations for conducting Audit Sampling



1.18 Steps in Sample Selection



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1.18.1 Design & select audit sample

When designing an audit sample, the auditor shall

- Consider the purpose of the audit procedure and the characteristics of the population from which the sample will be drawn
- Determine a sample size sufficient to reduce sampling risk to an acceptably low level. Sample size

Sample need to be **representative of entire population,** irrespective of approach non-statistical or statistical sampling. Samples must be closely similar to the whole population although not necessarily exactly the same.

will depend on the degree of

- Sampling risk,
- Tolerable misstatement range of the auditor and
- Expected error.

More the sampling risk and expected errors, bigger shall be the sample size and vis a vis. More the tolerable misstatement range of the auditor lesser will be the sample size and vis a vis.

Here tolerable misstatement means a monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population

- Select items for the sample in such a way that each sample unit in the population has a chance of selection



1.18.2 Performing Audit Procedures

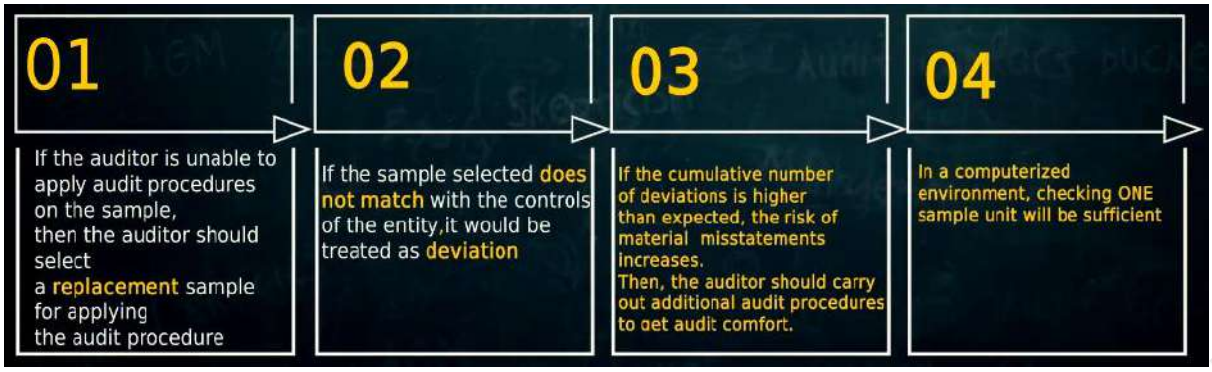
- The auditor shall perform audit procedures, appropriate to the purpose, on each item selected
- If the audit procedure is not applicable to the selected item, the auditor shall perform the procedure on a replacement item.
- If the auditor is unable to apply the designed audit procedures, or suitable alternative procedures, to a selected item, the auditor shall treat them as a
  - Deviation from the prescribed control, in the case of tests of control
  - A misstatement in the case of test of details

1.18.3 Investigate nature and cause of deviation and misstatement

- The auditor shall investigate the nature and cause of any deviations or misstatements identified, and evaluate their possible effect on the purpose of the audit procedure and on other areas of the audit
- In the extremely rare circumstances when the auditor considers a misstatement or deviation discovered in a sample to be an anomaly, the auditor shall obtain a high degree of certainty that such misstatement or deviation is not representative of the population.

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- The auditor shall obtain this degree of certainty by performing additional audit procedures to obtain sufficient appropriate audit evidence that the misstatement or deviation does not affect the remainder of the population.



Auditor may communicate any deviations to the management as per SA 260

1.18.4 Project Mis-statement

For tests of details, the auditor shall project misstatements found in the sample to the population
For tests of controls, no explicit projection of deviations is necessary since the sample deviation rate is also the projected deviation rate for the population as a whole.

1.18.5 Evaluation results of audit sampling

The auditor shall evaluate

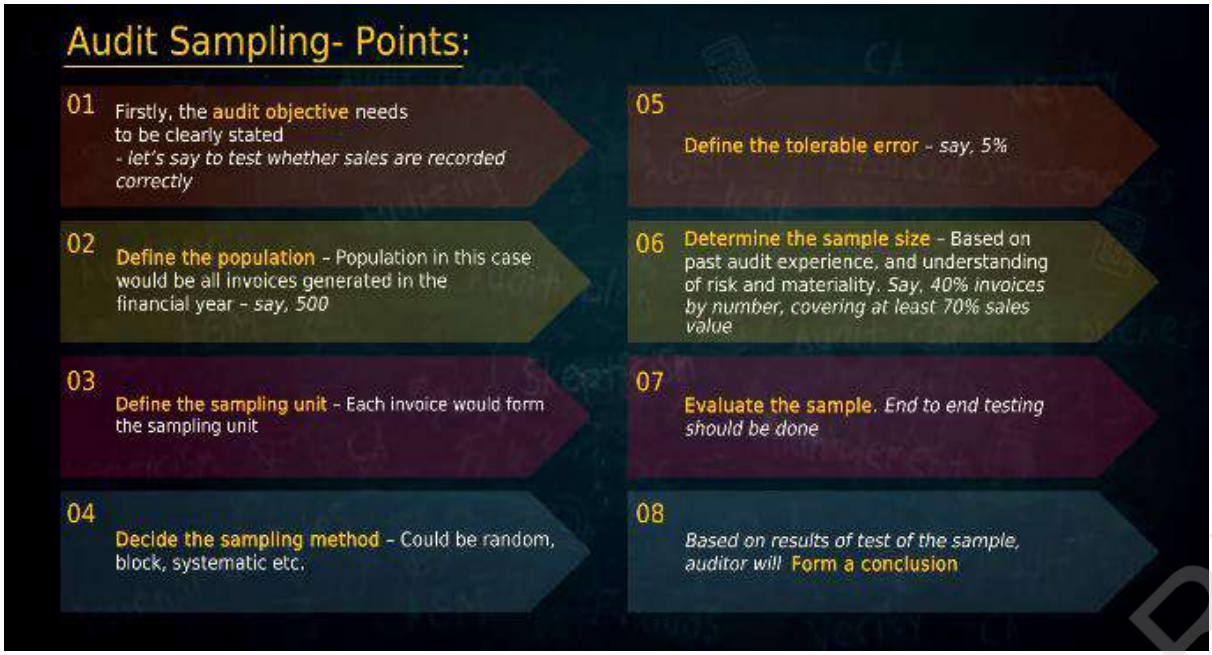
- The results of the sample; and
- Whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested.

If the auditor concludes that audit sampling has not provided a reasonable basis for conclusions about the population that has been tested, the auditor may:

- Request management to investigate misstatements that have been identified and the potential for further misstatements and to make any necessary adjustments; or
- Tailor the nature, timing and extent of those further audit procedures to best achieve the required assurance.

If any error or misstatement identified, auditor shall after management's investigation into its nature and cause, evaluate their possible effect on the purpose of the audit procedure and on other areas of the audit.

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1.18.6 Documentation

Auditor shall document sampling techniques used. That shall include

- How sample was selected?
- How was the sample analysed?
- What was the result of sampling?

1.19 Sample Selection Methods

There are many methods of selecting samples. The principal methods are as follows:

1.19.1 Random Selection

Applied through random number generators, for example, random number tables.

1.19.2 Systematic Selection/ Interval Selection

- The number of sampling units in the population is divided by the sample size to give a sampling interval, for example 50, and having determined a starting point within the first 50, each 50th sampling unit thereafter is selected.
- Although the starting point may be determined haphazardly, the sample is more likely to be truly random if it is determined by use of a computerized random number of generator or random number tables.
- When using systematic selection, the auditor would need to determine that sampling units within the population are not structured in such a way that the sampling interval corresponds with a particular pattern in the population.

1.19.3 Monetary Unit Sampling

It is a type of value-weighted selection in which sample size, selection and evaluation results in a conclusion in monetary amounts.

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1.19.4 Haphazard Selection

- The auditor selects the sample without following a structured technique.
- Although no structured technique is used, the auditor would nonetheless avoid any conscious bias or predictability (for example, avoiding difficult to locate items, or always choosing or avoiding the first or last entries on a page) and thus attempt to ensure that all items in the population have a chance of selection.

Haphazard selection is not appropriate when using statistical sampling.

1.19.5 Block Selection

- It involves selection of a block(s) of contiguous items from within the population.
- Block selection cannot ordinarily be used in audit sampling because most populations are structured such that items in a sequence can be expected to have similar characteristics to each other, but different characteristics from items elsewhere in the population.
- Although in some circumstances it may be an appropriate audit procedure to examine a block of items, it would rarely be an appropriate sample selection technique when the auditor intends to draw valid inferences about the entire population based on the sample.

Cluster Sampling vs Block Sampling

Dividing the population into groups of items is known as Cluster sampling.
Block sampling involves the selection of a defined block of consecutive items.

1.20 Sampling Not Suitable in Certain Circumstances

- Population too small
- Heterogeneous population
- Improper maintenance of population data
- Certain transactions like
  - Opening and closing entries
  - Bank reconciliation statement
  - Balance sheet items
  - Mattes involving computation
  - Transactions that may be small in number but important and material
  - Transactions which are not recognized by law to be looked into by the auditor carefully
  - Seasonal industry, where test checking is carried out on annual basis
  - Transactions of non-recurring nature or exceptional transactions

1.21 Advantages of Statistical Sampling

- The amount of testing (sample size) does not increase in proportion to the increase in the size of the area (universe) tested.

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- The sample selection is more objective and thereby more defensible.
- The method provides means of estimating the minimum sample size associated with a specified risk & precision.
- It provides a means for deriving a "calculated risk" and corresponding precision (sampling error) i.e. the probable difference in result due to the use of a sample in lieu of examining all the records in the group (universe), using the same audit procedures.
- It may provide a better description of a large mass of data than a complete examination of all the data, since non-sampling errors such as processing and clerical mistakes are not as large.

1.22 Stratification vs Value Weighed Sampling

In considering the characteristics of the population from which the sample will be drawn, the auditor may determine that stratification or value-weighted selection is appropriate.

1.22.1 Stratification

Stratification may be defined as the process of dividing a population into sub-populations, each of which is a group of sampling units which have similar characteristics (often monetary value).
Every such group so divided is called strata. Each stratum is treated as if it were a separate population and proportionate items are selected from each of the stratum. The groups into which the whole population is divided is determined by the auditor on the basis of his judgement.
Eg:

S.No	Strata Details of Purchase vouchers	Items selected for checking
(a)	Vouchers above ₹10,00,000	100%
(b)	Vouchers between ₹2,50,000 and ₹10,00,000	50%
(c)	Vouchers below ₹2,50,000	25%

The reasoning behind the stratified sampling is that for a highly diversified population, weights should be allocated to reflect these differences. This is achieved by selecting different proportions from each strata.

1.22.2 Value weighed selection

- When performing tests of details, it may be efficient to identify the sampling unit as the individual monetary units that make up the population.
- One benefit of this approach to defining the sampling unit is that audit effort is directed to the larger value items because they have a greater chance of selection and can result in smaller sample sizes.
- This approach may be used in conjunction with the systematic method of sample selection and is most efficient when selecting items using random selection.

1.23 Factors affect extent of Checking

1.23.1 Checking for Test of controls

An increase in the extent to which the auditor's risk assessment takes into account relevant controls will increase the sample size.

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(ii) An increase in the tolerable rate of deviation, will decrease the sample size.
An increase in the expected rate of deviation of the population to be tested, will increase the sample size.
(iv) An increase in the auditor's desired level of assurance that the tolerable rate of deviation is not exceeded by the actual rate of deviation in the population will increase the sample size.

1.23.2 Checking for Test of Details

An increase in the auditor's assessment of the risk of material misstatement will increase the extent of checking.
(ii) An increase in the use of other substantive procedures directed at the same assertion will decrease the extent of checking.
(iii) An increase in the auditor's desired level of assurance that tolerable misstatement is not exceeded by actual misstatement in the population will increase the extent of checking.
(iv) An increase in tolerable misstatement will decrease the
extent of checking.
(v) An increase in the amount of misstatement the auditor expects to find in the population will increase the extent of checking.
(vi) Stratification of the population when appropriatewill decrease the extent of checking.

1.24 Questions

1) There is a growing realisation that the traditional approach to audit is economically wasteful because all efforts are directed to check all transactions without exception. Explain. [RTP-Nov. 19]
2) The extent of the checking to be undertaken is primarily a matter of judgment of the auditor. It is in the interest of the auditor that if he decides to form his opinion on the basis of a part checking, he should adopt standards and techniques which are widely followed. Explain. [RTP-Nov. 19]
3) What is the meaning and purposes of sampling. Explain in the light of SA 520 "Audit Sampling". [Nov. 06 (8 Marks)]
4) Whatever may be the approach non-statistical or statistical sampling, the sample must be representative. Discuss explaining Statistical and Non-Statistical sampling approaches. [RTP-May 18]
5) Write short note on: Advantages of Statistical Sampling. Nov. 11, May 14 (4 Marks)]
6) While planning the audit of S Ltd, you want to apply sampling techniques. What are the risk factors you should keep in mind. [RTP-Nov. 18, MTP-April 19]
7) "Sampling risk can lead to erroneous conclusion". Justify. [May 19 (4 Marks)]
8) Discuss the following: With reference to SA 530, meaning of audit sampling and requirements relating to sample design, sample size and selection of items for testing. [May 16 (5 Marks)]
9) Write short note on: Stratified sampling. [May 11 (5 Marks)]
10) XYZ Ltd is engaged in trading of electronic goods and having huge accounts receivables. For analysing the whole accounts receivables, auditor wanted to use sampling technique. In

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considering the characteristics of the population from which the sample will be drawn, the auditor determines that stratification or value-weighted selection technique is appropriate. SA 530 provides guidance to the auditor on the use of stratification and value-weighted sampling techniques. Advise the auditor in accordance with SA 530. [RTP-May 18, MTP-Oct. 19]

11) Discuss the following: The level of sampling risk that the auditor is willing to accept affects the sample size required. The lower the risk the auditor is willing to accept, the greater the sample size will need to be. Explain Stating the examples of factors that the auditor may consider when determining the sample size for tests of controls. [MTP-March 18]
12) The sample size can be determined by the application of a statisticallybased formula or through the exercise of professional judgment. When circumstances are similar, the effect on sample size of factors will be similar regardless of whether a statistical or non-statistical approach is chosen. Explain Stating the examples of factors that the auditor may consider when determining the sample size for tests of controls. [MTP-Oct. 18]
13) Discuss the factors that should be considered for deciding upon the extent of checking on a sampling plan. [RTP-May 19]
14) Write short note on: Random Sampling. [May 12, May 15 (4 Marks), May 17 (6 Marks)]
15) Write short note on: Haphazard sampling. [Nov. 17 (4 Marks)]
16) Explain the sampling method which involves selection of a block(s) of contiguous items from within the population. Also give example. [RTP-May 20]
17) The auditor is required to project misstatements for the population to obtain a broad view of the scale of misstatement. Explain. [RTP-May 19]
18) The auditor is required to project misstatements for the population to obtain a broad view of the scale of misstatement but this projection may not be sufficient to determine an amount to be recorded. Explain. [RTP-May 20]

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CHAPTER 14 – PROVISIONS RELATING TO AUDIT UNDER COMPANIES ACT

UNIT 1 - THE COMPANY AUDIT

1. Requirement of Company Audit

Companies Act, 2013 is rule based Act. The provisions relating to 'Audit' in Companies Act, 2013 broadly deal with who can be appointed as an auditor under the Act, i.e., qualifications and disqualifications, the manner of appointment and removal of an auditor and rights and duties of an auditor. The Management has certain responsibilities in the company listed below.

Management responsibilities

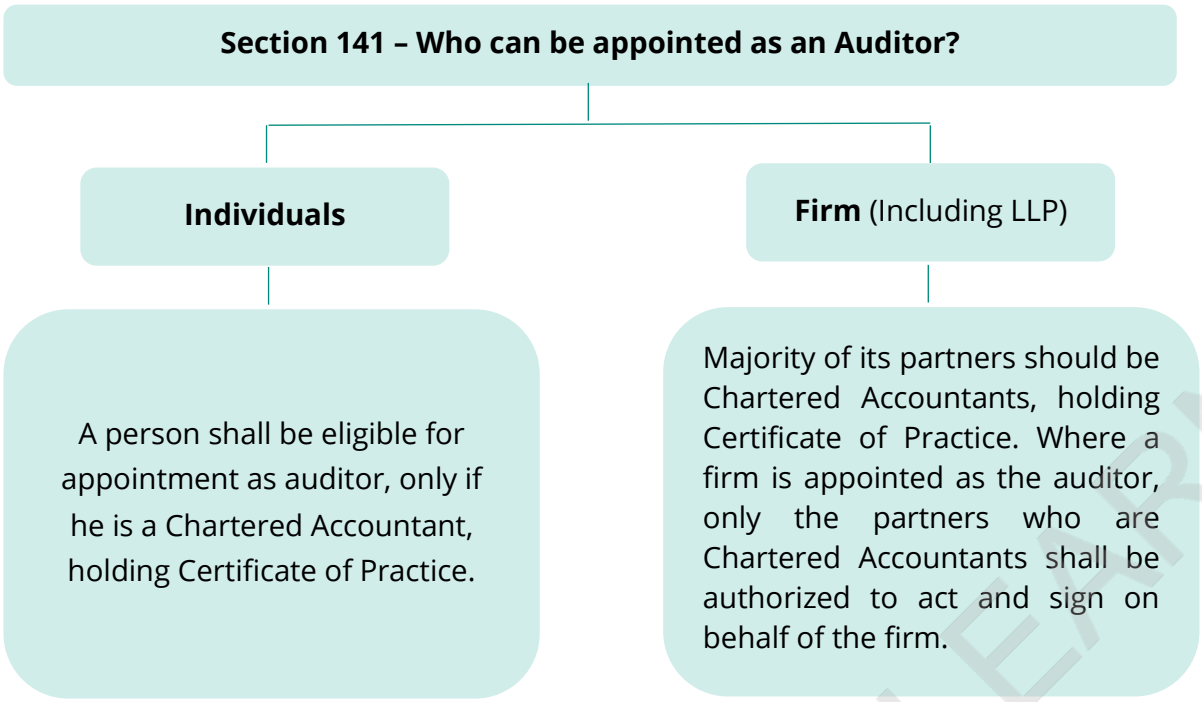
- Maintain proper books of Accounts
- Proper Internal Controls
- Safeguard Assets
- Comply with Laws & Regulations
- Comply with Accounting principles & Standards
- Prepare Financial statements.

The Members can neither go into the company to check if the Management is carrying out its responsibilities properly nor trust the Management without any evidence. To check whether the amount invested by the investors is properly being utilized, an Auditor is appointed.

2. Who can be appointed as an Auditor?

The provisions relating to eligibility, qualifications and disqualifications of an auditor are governed by ***Section 141 of the Companies Act, 2013***. The main provisions are stated below:

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Note – LLPs can operate with non-CA partners in line with international standards.

Case Study – 1
Preksha, a member of the ICAI, does not hold a Certificate of practice. Is her appointment as an auditor valid?
Answer:
Qualifications of an Auditor: *A person shall be qualified for appointment as an auditor of a company, **only if one is a Chartered Accountant within the meaning of the Chartered Accountants Act, 1949**. Under the Chartered Accountants Act, 1949, only a Chartered Accountant holding the certificate of practice can engage in public practice. Preksha does not hold a certificate of practice and hence cannot be appointed as an auditor of a company.*

3. Disqualifications

Under sub-section (3) of section 141 along with Rule 10 of the Companies (Audit and Auditors) Rule, 2014 (hereinafter referred as CAAR), the following persons shall not be eligible for appointment as an auditor of a company, namely:

- ***Body Corporate (Except LLP)***
  - Company as defined under Companies Act cannot be appointed as an Auditor of a company
  - LLP, though a corporate is an exception as a disqualification for Company Audit.
  - LLP with majority of partners as CA's with Certificate of Practice (CoP) from ICAI is eligible for Company Audit.

- ***An officer or employee of the Company.***

An officer or employee of the Company cannot be appointed as an Auditor as the Management might influence such officer's or employee's opinion.

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- ***A partner or employee of the officer or employee of the Company.***

- ***A person who, or his relative, or partner***
  - Holding any security of/ interest in the company/ its subsidiary/ its holding/associate or any fellow subsidiary.
    - The relative may hold security or interest in the company of face value not exceeding Rs.100000.
    - If the relative acquires security or interest of face value exceeding Rs.100000,
    - Further, in the event of acquiring security or interest by a ***relative*** above the threshold limit of Rs.100000, it should come back to the prescribed limits within 60 days of such acquisition of interest, failing which the auditor will be deemed to have vacated the office.
  - **Section 2(77) of the Companies Act, 2013**
    Relative – A person shall be deemed to be the relative of another, if he or she is related to another in the following manner, namely
    - Members of HUF
    - Husband and Wife
    - Father including stepfather
    - Mother including stepmother
    - Son including stepson
    - Son's wife
    - Daughter
    - Daughter's husband
    - Brother including stepbrother
    - Sister including stepsister.
  - Indebted to the Company/ its subsidiary/ holding/ associate/ fellow subsidiary in excess of Rs. 500000 (i.e. the limit is applicable to the person, or his relative or partner).
  - Has given guarantee or provided any security in connection with indebtedness if third party to the Company/ its subsidiary/ its holding/ associate/ fellow subsidiary for more than Rs. 100000.

- ***A person or a firm who, whether directly or indirectly has business relationship with the Company, or its Subsidiary, or its Holding or Associate Company or Subsidiary of such holding company or associate company, of such nature as may be prescribed.***
  - The term "directly or indirectly" above includes a relative.
  - Business relationship does not include –
    - Professional services of a CA firm – Commercial transactions which are in the nature of professional services permitted to be rendered by an Auditor or Audit firm under the Act and the Chartered Accountants Act, 1949 and the rules or the regulations made under those Acts.
    - Transactions in ordinary course of business as a customer (Arm's length transaction) – Commercial transactions which are in the ordinary course of business of the company at Arm's length price- like sale of products or services to auditors, as customers, in the ordinary

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course of business, by companies engaged in the business of Telecom, Hospitals, Hotels, Airlines etc.

- ***A person who's relative is –***
  - A Director; or
  - Is in the employment of the Company as a Director or key managerial personnel.

- ***A person who is holding appointment as auditor for more than twenty companies. The limit of 20 companies is excluding One person companies, Dormant companies, Small companies, and Private companies (Paid up share capital < Rs.100 crores).***

- ***A person who is in full time employment elsewhere.***

- ***A person who***
  - Has been convicted by court of an offense involving fraud; and
  - A period of ten years has not elapsed since the date of conviction.
- ***Any person whose subsidiary or associate company or any other form of entity, is engaged as on the date of appointment in consulting and specialised services as provided in Section 144 (Services affecting the independence of Auditor).***

Section 144 of Companies Act, 2013 – Services affecting the independence of Auditor

An auditor appointed under this Act shall provide to the company only such other services as are approved by the Board of Directors or the Audit committee, as the case may be. But such services shall not include any of the following services (whether such services are rendered directly or indirectly to the company or its holding company or subsidiary company), namely

- Accounting and bookkeeping services
- Internal audit
- Design and implementation of any financial information system
- Actuarial services
- Investment advisory services
- Investment banking services
- Rendering of outsourced financial services
- Management services [this excludes services permitted by ICAI as per professional ethics] and
- Any other kind of services as may be prescribed [E.g. Prohibited services by CA in practice as per ICAI like Portfolio management, Underwriting and Stock broking are under this category]

If any of these disqualifications are attracted after appointment, then the Auditor shall be deemed to have vacated the office.

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Examination tips –

- Determine if the question is about qualification or disqualification.
- Give adequate explanation considering the provisions & rules (Sections need not be quoted).
- Answer directly the question asked, do not give all the provisions.
- Disregard the irrelevant information given in the question, concentrate only on the relevant aspects.
- Pictorial representation of facts given can be used.
- Analysis – Give reference to relevant provisions of the Act.
- Conclusion – Categorical.
- In case of ambiguity or incomplete information – Give all the possible scenarios.

4. Appointment of Auditors

Every company shall, ***at the first annual general meeting*** appoint an individual or a firm as an auditor who shall hold office from the conclusion of that meeting till the ***conclusion of its sixth annual general meeting*** and thereafter till the conclusion of every sixth meeting.

4.1 Appointment of First Auditor for other than a Government Company

The first auditor of a company, other than a Government Company, shall be appointed by:

- Board of Directors within 30 days of Registration of company or
- Members within 90 days, at Extraordinary General Meeting (EGM)

Term of the Auditor - Till the conclusion of the ***first annual general meeting.***

4.2 Appointment of Subsequent Auditor for other than a Government Company

- Competent authority for appointment is –
  - If constitution of Audit Committee is needed for company, then Audit Committee
  - Else, Board of Directors.
- The Competent Authority, if Audit Committee, shall recommend auditor to the Board for consideration.
  - If the Board does not agree with the recommendation - it shall refer back to Audit Committee for reconsideration, with reasons.
  - If the Board agrees with the recommendation - it shall recommend appointment of such auditors to members in AGM.
- In case of disagreement between the Audit Committee and the Board of Directors
  - If the Audit Committee agrees with the Board's reasons for reconsideration, then it shall place the Board's recommendation before members in AGM.

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- If the Audit Committee disagrees with the Board's reason for reconsideration, the Board shall record reasons for disagreement and send this fact to the members for their consideration in AGM.

- Prior to the appointment, a certificate shall be obtained from the Auditor stating that the
  - Auditor ***is qualified*** for appointment
  - Auditor ***is not disqualified*** for appointment
  - Proposed appointment is as per the Act, and ***within the limits*** prescribed.
  - ***Disclosure of any cases of professional misconduct*** pending against the proposed auditor or his firm, or his partner.
- Under Rule 4 of The Companies (Audit and Auditors) Rules, 2014, the said certificate shall state the following:
  - the individual or the firm, as the case may be, is eligible for appointment and is not disqualified for appointment under the Act, the Chartered Accountants Act, 1949 and the rules or regulations made thereunder;
  - the proposed appointment is as per the term provided under the Act;
  - the proposed appointment is within the limits laid down by or under the authority of the Act;
  - the list of proceedings against the auditor or audit firm or any partner of the audit firm pending with respect to professional matters of conduct, as disclosed in the certificate, is true and correct.
- ***Form ADT-1*** shall be filed with the ROC by the company, ***within 15 days*** of meeting in which the auditor is appointed or re-appointed. Also, the concerned auditor shall be informed.

Term of the Auditor - Till the conclusion of the ***sixth annual general meeting.***

4.3 Appointment of First Auditor in case of a Government Company

- **Government company – Sec2(45) of the Companies Act, 2013**
  Any company (includes subsidiary company of such a Government company) in which greater than or equal to (i.e., not less than) 51% of the paid-up share capital is held by
  - The Central Government, or
  - Any State Government or Governments, or
  - Partly by the Central Government and partly by one or more State Governments.
- The first auditor of a Government Company, shall be appointed by:
  - Comptroller & Auditor General of India (C&AG) within 60 days of registration of the company or
  - Board of Directors within next 30 days or
  - Members within next 60 days, at Extraordinary General Meeting (EGM).

Term of the Auditor - Till the conclusion of the ***first annual general meeting.***

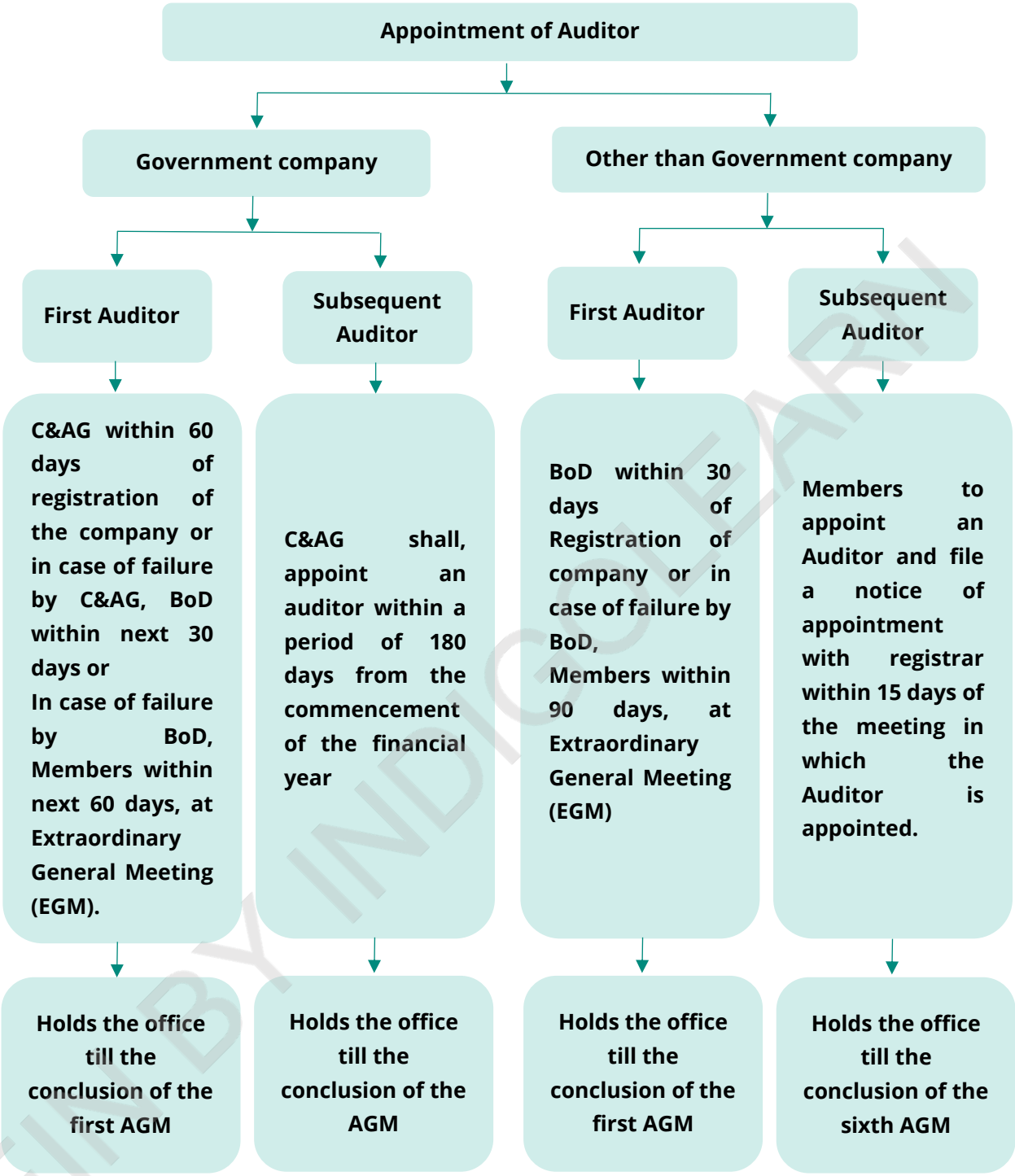
4.4 Appointment of Subsequent Auditor in case of a Government Company u/s 139(5)

C&AG shall appoint within 180 days from commencement of financial year in the case of:

- A Government company or
- Any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government or Governments, or partly by the Central Government and partly by one or more State Governments.

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Term of the Auditor - Till the conclusion of the Annual General Meeting.



5. Filling of a casual vacancy (Under section 139(8))

- Auditor is validly appointed but before completion of full term, Auditor's office came to an end. Reasons for casual vacancy are
  - Death of the Auditor
  - Auditor is disqualified during the term
  - Auditor resigned.
- In Case of Government co.
  - C&AG to appoint the Auditor within 30 days or

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- Board of Directors within next 30 days
- In case of co. other than Government co.
  - For casual vacancy (for reasons other than resignation), Board of directors shall fill within 30 days of vacancy.
  - For casual vacancy (resignation), Board of Director's shall make a recommendation and within 3 months from such recommendation, Appointment shall be approved in Extraordinary General Meeting.
- **Term of the Auditor - Until the conclusion of the next annual general meeting.**

Scenario	Who?	When?
Casual Vacancy (Except Resignation)	**Board of Directors**	**Within 30 days**
Resignation	**Recommended by Board & Approved by shareholders in General Meeting**	**Within 3 months of Board Recommendation**
Casual Vacancy for C&AG appointed Auditors	**C&AG or Board of Directors**	**Within 30 days**

6. Resignation by Auditor

- If the Auditor has resigned from the company, he shall file within a period of 30 days from the date of resignation, a statement in Form ADT 3.
  - ***In case of government companies***, the auditor shall file such statement
    - with the Comptroller and Auditor-General of India
    - Company and
    - ROC.
  - ***In other cases***,
    - with the company and
    - ROC.
- The auditor shall indicate the reasons and other facts as may be relevant with regard to his resignation, in the statement.

Penalty on non-compliance shall not be less than Rs 50,000 but which may extend to Rs 5 Lacs.

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Case Study

'At the AGM of ICI Ltd., Mr. X was appointed as the statutory auditor. He, however, resigned after 3 months since he wanted to give up practice and join industry. State, how the new auditor will be appointed by ICI Ltd and the conditions to be complied for.

Answer:

Appointment of New Auditor in case of Resignation: Section 139(8) of the Companies Act, 2013 deal with provisions relating to appointment of auditor caused due to casual vacancy. A casual vacancy normally arises when an auditor ceases to act as such after he has been validly appointed, e.g., death, disqualification, resignation, etc. In the instance case, Mr. X has been validly appointed and thereafter he had resigned.

The law provides that in case a casual vacancy has been created by the resignation of the auditor (as in this case), the Board cannot fill in that vacancy itself, such appointment shall also be approved by the company at general meeting convened within three months of the recommendation of the board and then he shall hold office till the conclusion of the next annual general meeting.

In this case the casual vacancy has been created on account of resignation.

7. Reappointment of retiring Auditor

- At any annual general meeting, a retiring auditor may be re-appointed at an AGM, if-
  - he is not disqualified for re-appointment:
  - he has not given the company a notice in writing of his unwillingness to be re-appointed; and
  - a special resolution has not been passed at that meeting appointing some other auditor or providing expressly that he shall not be re-appointed.

Case Study –

M/s Young & Co., a Chartered Accountant firm, and Statutory Auditors of Old Ltd., is dissolved on 1.4.2014 due to differences of opinion among the partners. The Board of Directors of Old Ltd. in its meeting on 6.4.2014 appointed another firm M/s Sharp & Co. as their new auditors for one year.

Answer:

Section 139(8) of the Companies Act, 2013 lays down that the Board of Directors may fill any casual vacancy in the office of an auditor provided that where such vacancy is caused by the resignation of an auditor, the vacancy shall be filled in

- Where at any annual general meeting, no auditor is appointed or re-appointed, the existing auditor shall continue to be the auditor of the company.
- ***Where a company is required to constitute an Audit Committee under section 177, all***

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appointments, including the filling of a casual vacancy of an auditor under this section shall be made after taking into account the recommendations of such committee.

Case Study

Under what circumstances the retiring Auditor cannot be reappointed?

Answer:

In the following circumstances, the retiring auditor cannot be reappointed:

- *A specific resolution has not been passed to reappoint the retiring auditor.*
- *The auditor proposed to be reappointed does not possess the qualification prescribed under section 141 of the Companies Act, 2013.*
- *The proposed auditor suffers from the disqualifications under section 141(3), 141(4) and 144 of the Companies Act, 2013.*
- *He has given to the company notice in writing of his unwillingness to be reappointed.*
- *A resolution has been passed in AGM appointing somebody else or providing expressly that the retiring auditor shall not be reappointed.*
- *A written certificate has not been obtained from the proposed auditor to the effect that the appointment or reappointment, if made, will be in accordance with the limits specified under section 141(3)(g) of the Companies Act, 2013.*

8. Term of Auditor

If Audit is continued by the same person for long, it might lead to reduction in professional scepticism resulting in low quality of Audit. Hence, the concept of Rotation of Auditors came into force to safeguard the public interest.

8.1 Applicability of section 139(2)

"Rotation of Auditors" is applicable to the following "class of companies".

Category	Rotation Applicable u/s 139 (2)
Listed Companies	Yes
Unlisted Public Companies	PUC >= Rs. 10 Crores
Private Companies	PUC >= Rs. 50 Crores
Unlisted/Private Companies	Public Deposits + Borrowings >= Rs. 50 Crores

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8.2 Term of Auditors

Individual Auditor	**Term:** One term of 5 years	**Cooling period:** 5 years
Audit firm	**Term:** Two terms of 5 years	**Cooling period:** 5 years

8.3 Joint Auditor's reappointment

2 or more firms / individuals are to be appointed in such a way that both or all the joint auditors do not complete their term in the same year.

8.4 Firms with common partners

If firm that has just completed its term and proposed firm has common partners, then such proposed firm would be ineligible to be appointed as auditors.

Example –

- M/s Krishna & Associates is an audit firm having 2 partners namely Mr. Krishna and Mr. Shyam. Mr. Shyam is also a partner of another audit firm named M/s Kukreja & Associates.
- M/s Krishna & Associates was appointed as the auditors in the company Golden Smith Ltd. for two consecutive periods i.e. from year 2014 to year 2024.
- Now, if Golden Smith Ltd. wants to appoint Ms Kukreja & Associates as its audit firm, it can not do so because Mr. Shyam was the common partner between both the Audit firms.
- This prohibition is only for 5 years i.e. upto year 2029. After 5 years Golden Smith Ltd. may appoint M/s Kukreja & Associates as its auditors.

8.5 Transitional Provisions

- Transition period for Companies existing on or before commencement of the Act is 3 years from the date of commencement of this Act.
- Period for which office as auditor is held prior to commencement of this act should also be considered for rotation and cooling period.
- The incoming auditor or audit firm should not be in same network of audit firms as the outgoing auditor i.e., firms operating or functioning under the same brand name, trade name or common control.

If a signing partner resigns from the firm which is appointed as auditor of a company and joins another firm, then such other firm is ineligible for appointment as auditor for 5 years i.e., cooling period rule applies.

8.6 Ratification of appointment:

The appointment shall be subject to ratification in every AGM till the 6th meeting by way of passing of an ordinary resolution.

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If not ratified, the Board of Directors shall appoint another individual or firm as its auditor or auditors after following the procedure laid down in this behalf under the Act.

Illustration explaining rotation of an individual auditor

Number of consecutive years for which an individual Auditor has been functioning as auditor in the same company [in the first AGM held after the commencement of provisions of section 139(2)	**Maximum number of consecutive years for which he may be appointed in the same company (including transitional period)**	**Aggregate period which the auditor would complete in the same company in view of column I and II**
I	II	III
5 Years (or more than 5 years)	3 years	8 years or more
4 years	3 years	7 years
3 years	3 years	6 years
2 years	3 years	5 years
1 year	4 years	5 years

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Illustration explaining rotation of an audit firm

Number of consecutive years for which an audit firm was functioning as auditor in the same company [in the first AGM held after the commencement of provisions of section 139(2)]	Maximum number of consecutive years for which the firm may be appointed in the same company (including transitional period)	Aggregate period which the firm would complete in the same company in view of column I and II
I	II	III
10 Years (or <)	3 years	13 years or more
9 years	3 years	12 years
8 years	3 years	11 years
7 years	3 years	10 years
6 years	4 years	10 years
5 years	5 years	10 years
4 years	6 years	10 years
3 years	7 years	10 years
2 years	8 years	10 years
1 year	9 years	10 years

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8.7 Resolution by members

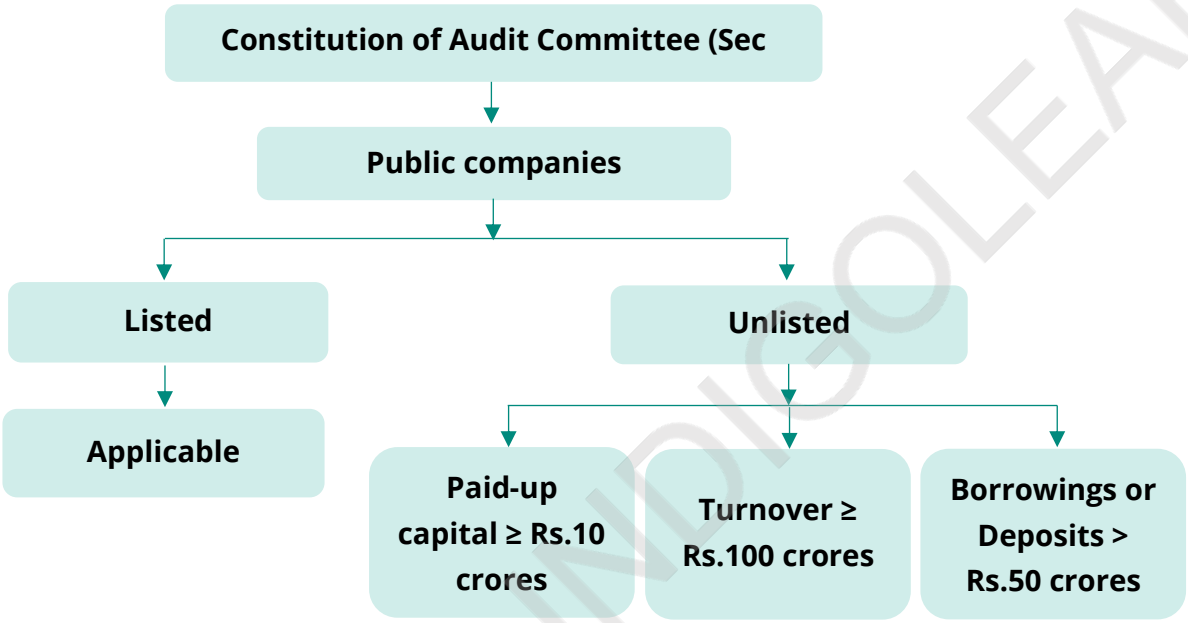
- Members may resolve to rotate partners of appointed audit firm at intervals (change in signing partners) or
- The audit shall be conducted by more than one auditor.

These resolutions are optional.

As you would have noticed, the provisions relating to disqualifications and rotation of auditors are meant to ensure that audit function remains unbiased. These legal provisions also provide enough safeguards so that auditors can form their opinion in an independent and highly professional manner without any bias.

9. Audit committee

- Most part of the Audit committee are Independent.
- Audit committee is not compulsory for every company.



9.1 Manner and procedure of selection and appointment of auditors

Rule 3 of CAAR, 2014 prescribes the following manner and procedure of selection and appointment of auditors-

- In case of a company that is required to constitute an Audit Committee under section 177, the committee, and, in cases where such a committee is not required to be constituted, the Board, shall take into consideration the qualifications and experience of the individual or the firm proposed to be considered for appointment as auditor and whether such qualifications and experience are commensurate with the size and requirements of the company. It may be noted that while considering the appointment, the Audit Committee or the Board, as the case may be, shall have regard to any order or pending proceeding relating to professional matters of conduct against the proposed auditor before the Institute of Chartered Accountants of India or any competent authority or any Court.
- The Audit Committee or the Board, as the case may be, may call for such other information from the proposed auditor as it may deem fit.
- Subject to the provisions of sub-rule (1), where a company is required to constitute the Audit Committee, the committee shall recommend the name of an individual or a firm as auditor to the

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Board for consideration and in other cases, the Board shall consider and recommend an individual or a firm as auditor to the members in the annual general meeting for appointment.

- If the Board agrees with the recommendation of the Audit Committee, it shall further recommend the appointment of an individual or a firm as auditor to the members in the annual general meeting.
- If the Board disagrees with the recommendation of the Audit Committee, it shall refer back the recommendation to the committee for reconsideration citing reasons for such disagreement.
- If the Audit Committee, after considering the reasons given by the Board, decides not to reconsider its original recommendation, the Board shall record reasons for its disagreement with the committee and send its own recommendation for consideration of the members in the annual general meeting; and if the Board agrees with the recommendations of the Audit Committee, it shall place the matter for consideration by members in the annual general meeting.
- The auditor appointed in the annual general meeting shall hold office from the conclusion of that meeting till the conclusion of the sixth annual general meeting, with the meeting wherein such appointment has been made being counted as the first meeting.

10. Auditor's remuneration

- The remuneration of the auditors of a company shall be fixed by the company in general meeting or in such manner as the company in general meeting may determine.
- In the case of first auditor, remuneration may be fixed by the Board.
- The remuneration shall include the fee payable, expenses incurred in connection with the audit and any facility extended to him, but not remuneration paid to him for any other service rendered at the request of the company.

11. Removal of Auditor before expiry of term

- The auditor may be removed from his office before the expiry of his term by
  - a ***special resolution of the company***, and
  - After obtaining the ***previous approval of the Central Government*** (fee paid application form ADT 2)
- The application shall be made to the Central Government ***within 30 days of the resolution passed by the Board***.
- The Company shall hold the general meeting within 60 days of receipt of approval of the Central Government for passing the special resolution.
- The auditor shall have an opportunity of being heard.
- Auditor can also be removed by the Tribunal.
- Central Government can make an application to tribunal for removal of Auditor.
- Within 15 days of receipt of Central Government application by Tribunal, communication of removal should be made by the Tribunal.
- Any person can make an application for removal of Auditor to Tribunal.

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- The removed auditor cannot be re-appointed till 5 years.

Case Study

Why is Central Government permission required, when the auditors are to be removed before expiry of their term, but the same is not needed when the auditors are changed after expiry of their term?

Answer:

Permission of Central Government for removal of auditor under section 140(1) of the Companies Act, 2013:

Removal of auditor before expiry of his term i.e. before he has submitted his report is a serious matter and may adversely affect his independence.

Further, in case of conflict of interest the shareholders may remove the auditors in their own interest.

Therefore, law has provided this safeguard so that central government may know the reasons for such an action and if not satisfied, may not accord approval.

On the other hand, if auditor has completed his term i.e. has submitted his report and thereafter, he is not re-appointed then the matter is not serious enough for central government to call for its intervention. In view of the above, the permission of the Central Government is required when auditors are removed before expiry of their term and the same is not needed when they are not re-appointed after expiry of their term.

12. Appointment of Auditor other than the retiring Auditor

- If the retiring auditor has not completed a consecutive tenure of 5 years or 10 years, as the case may be, **special notice** shall be required for
  - a resolution at an annual general meeting appointing as auditor a person other than a retiring auditor, or
  - Providing expressly that a retiring auditor shall not be re-appointed.
- On receipt of notice of such a resolution, the company shall send a copy thereof to the retiring auditor.
- Outgoing auditor has the right to give representation, —
  - in the notice of resolution given to members, stating fact that representation has been made
  - send a copy of the representation to every member of the company to whom notice of the meeting is sent
- If the company makes an application to the tribunal stating that the right to representation is abused by the Auditor and the tribunal is satisfied thereof,
  - Then the tribunal may instruct the company to not to read-out or circulate the representation in the meeting.

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If a copy of the representation is **not sent** as aforesaid, it shall be read out at the meeting, and a copy shall be filed with Registrar.

13. Ceiling on number of Audits

13.1 Company Audit

- The number of audits held at any point of time should not exceed 20 companies, other than one person companies, dormant companies, small companies and private companies having paid-up share capital less than Rs.100 crore.
- In the case of a firm of auditors, the ceiling limit of 20 shall be applicable **for every partner** of the firm who is not in full time employment elsewhere. This limit of 20 company audits is per person. In the case of an audit firm having 3 partners, the overall ceiling will be 3 × 20 = 60 company audits.
- Where a chartered accountant is a partner in a number of auditing firms, all the firms in which he is partner or proprietor **will be together entitled to 20 company audits** on his account.

13.2 Tax Audit

The number of tax audits held at any point of time should not exceed 60 for a Chartered Accountant who is not in full time employment elsewhere.

14. Powers/Rights of an Auditor

14.1 Right to examine the books of accounts and vouchers.

- Section 143(1) of the Act provides that the auditor of a company, at all times, shall have a right of access to the books of account and vouchers of the company, whether kept at the registered office of the company or at any other place and he is entitled to require from the officers of the company such information and explanation as he may consider necessary for the performance of his duties as auditor.
- The right of access is not limited to those books and records maintained at the registered or head office so that in the case of a company with branches, the right also extends to the branch records, if the auditor considers it necessary to have access thereto as per Section143(8).

14.2 Right to obtain information and explanation from officers.

- This right of the auditor to obtain from the officers of the company such information and explanations as he may think necessary for the performance of his duties as auditor is a wide and important power.
- It is for the auditor to decide the matters in respect of which information and explanations are required by him.
- When the auditor is not provided the information required by him or is denied access to books, etc., his only remedy would be to report to the members that he could not obtain all the information and explanations he had required or considered necessary for the performance of his duties as auditors.

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14.3 Right to receive notices and to attend general meeting.

- The auditors of a company are entitled to attend any general meeting of the company (the right is not restricted to those at which the accounts audited by them are to be discussed) and also to receive all the notices and other communications relating to the general meetings, which members are entitled to receive and to be heard at any general meeting in any part of the business of the meeting which concerns them as auditors.
- Section 146 states "all notices of, and other communications relating to, any general meeting shall be forwarded to the auditor of the company, and the auditor shall, unless otherwise exempted by the company, attend either by himself or through his authorised representative, who shall also be qualified to be an auditor, any general meeting and shall have right to be heard at such meeting on any part of the business which concerns him as the auditor."

14.4 Right to report to the members of the company on the accounts examined by him.

- The auditor shall make a report to the members of the company on the accounts examined by him and on every financial statements
- which are required by or under this Act to be laid before the company in general meeting and
- the report shall after taking into account the provisions of this Act, the accounting and auditing standards and matters which are required to be included in the audit report under the provisions of this Act or any rules made there under or under any order made under this section and to the best of his information and knowledge,
- the said accounts, financial statements give a true and fair view of the state of the company' s affairs as at the end of its financial year and profit or loss and cash flow for the year and such other matters as may be prescribed.

14.5 Right to Lien

- In terms of the general principles of law, any person having the lawful possession of somebody else's property, on which he has worked, may retain the property for non-payment of his dues on account of the work done on the property.
- On this premise, auditor can exercise lien on books and documents placed at his possession by the client for non-payment of fees, for work done on the books and documents.
- The Institute of Chartered Accountants in England and Wales has expressed a similar view on the following conditions:
  - Documents retained must belong to the client who owes the money.
  - Documents must have come into possession of the auditor on the authority of the client. They must not have been received through irregular or illegal means. In case of a company client, they must be received on the authority of the Board of Directors.
  - The auditor can retain the documents only if he has done work on the documents assigned to him.

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- Such of the documents can be retained which are connected with the work on which fees have not been paid.

Case Study

Give your comments and observations on the following:

a) *KBC & Co. a firm of Chartered Accountants has three partners, K, B & C; K is also in whole time employment elsewhere. The firm is offered the audit of ABC Ltd. and is already holding audit of 40 companies.*

b) *At an Annual General Meeting of a listed company, Mr. R a retiring auditor after completing the tenure of five consecutive years of his service claims that he has been reappointed automatically, as the intended resolution of which a notice had been given to appoint Mr. P, could not be proceeded with, due to Mr. P's death.*

Answer:

a) *Ceiling on Number of Company Audits: As per section 141(3)(g) of the Companies Act, 2013, a person shall not be eligible for appointment as an auditor if*

- *he is in full time employment elsewhere.*
- *if such person or partner is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies.*

In the firm of KBC & Co., K is in whole-time employment elsewhere, therefore, he will be excluded in determining the number of company audits that the firm can hold. If B and C do not hold any audits in their personal capacity or as partners of other firms, the total number of company audits that can be accepted by KBC & Co., is forty, and in the given case company is already holding forty audits, therefore, KBC & Co. can't accept the offer for audit of ABC Ltd.

b) *Term of Auditor: Section 139(2) of the Companies Act, 2013 deals with the term of an Auditor which provides that listed companies and other prescribed class or classes of companies (except one person companies and small companies) shall not appoint or reappoint an individual as auditor for more than one term of five consecutive years.*

In the given case, notice has been given of an intended resolution to appoint some person or persons in the place of a retiring auditor, and by reason of the death, incapacity or disqualification of that person or of all those persons,

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Case Study

PBS & Associates, a firm of Chartered Accountants, has three partners P, B and S. The firm is already having audit of 45 companies. The firm is offered 20 company audits. Decide and advise whether PBS & Associates will exceed the ceiling prescribed under Section 141(3)(g) of the Companies Act, 2013 by accepting the above audit assignments?

Answer:

Ceiling on number of audits: Before appointment is given to any auditor, the company must obtain a certificate from him to the effect that the appointment, if made, will not result in an excess holding of company audit by the auditor concerned over the limit laid down in section 141(3)(g) of the Act which prescribes that a person who is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such person or partner is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies.

In the case of a firm of auditors, it has been further provided that 'specified number of companies' shall be construed as the number of companies specified for every partner of the firm who is not in full time employment elsewhere.

If Mr. P, B and S do not hold any audits in their personal capacity or as partners of other firms, the total number of company audits that can be accepted by M/s PBS & Associates is 60. But the firm is already having audit of 45 companies. So, the firm an accept the audit of 15 companies only, which is well within the limit, specified by Section 141(3)(g) of the Companies Act, 2013.

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Case Study

What will be position of the Auditor in the following case:

A, a chartered accountant has been appointed as auditor of Laxman Ltd. In the Annual General Meeting of the company held in September 2013, which assignment he accepted. Subsequently in January 2014 he joined B, another chartered acountant, who is the Manager Finance of Laxman Ltd., as partner.

Answer:

Disqualifications of an Auditor: Section 141(3)(c) of the Companies Act, 2013 prescribes that any person who is a partner or in employment of an officer or employee of the company will be disqualified to act as an auditor of a company. Sub-section (4) of Section 141 provides that an auditor who incurs any of the disqualifications mentioned in sub-section (3) after his appointment, he shall vacate his office as such auditor.

In the present case, A, an auditor of M/s Laxman Ltd., joined as partner with B, who is Manager Finance of M/s Laxman Limited, has attracted clause (3) (c) of Section 141 and, therefore, he hall be deemed to have vacated office of the auditor of M/s Laxman Limited.

Case Study

Y, is the auditor of X Pvt. Ltd. In which there are four shareholders only, who are also the Directors of the company. On account of bad trade and for reducing the expenses in all directions, the directors asked Y to accept a reduced fee and for that he has been offered not to carry out such full audit as he has done in the past. Y accepted the suggestions of the directors.

Answer:

Restricting Scope of Audit: Y may agree to temporary reduction in audit fees, if he so wishes, in view of the suggestions made by the directors (perhaps in accordance with the decision of the company taken in general meeting). But his duties as a company auditor are laid down by law and no restriction of any kind can restrict the scope of his work either by the director or even by the entire body shareholders. There is no concept of full or part audit under Section 143 of the Companies Act, 2013. Further, remuneration is a matter of arrangement between the auditor and the shareholders.

Section 142 specifies the remuneration of an auditor, shall be fixed by the company in general meeting or in such manner as the company in general meeting may determine.

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Case Study

While conducting the audit of a limited company for the year ended 31st March 2014, the auditor wanted to refer to the Minute Books. The Board of Directors refused to show the Minute Books to the auditor.

Answer:

Right of Access to Minute Books: Section 143 of the Companies Act, 2013 grants powers to the auditor that every auditor has a right of access, at all times, to the books and account including all statutory records such as minute books, fixed assets register, etc. of the company for conducting the audit.

In order to verify actions of the company and to vouch and verify some of the transactions of the company, it is necessary for the auditor to refer to the decisions of the shareholders and/or the directors of the company.

Case Study

At the Annual General Meeting of the Company, a resolution was passed by the entire body of shareholders restricting some of the powers of the Statutory Auditors. Whether powers of the Statutory Auditors can be restricted?

Answer:

Restrictions on Powers of Statutory Auditors: Section 143 of the Companies Act, 2013 provides that an auditor of a company shall have right of access at all times to the books and accounts and vouchers of the company whether kept at the Head Office or other places and shall be entitled to require from the offices of the company such information and explanations as the auditor may think necessary for the purpose of his audit.

These specific rights have been conferred by the statute on the auditor to enable him to carry out his duties and responsibilities prescribed under the Act, which cannot be restricted or abridged in any manner. Hence, any such resolution even if passed by entire body of shareholders is ultra vires and therefore void.

15. Duties of auditor

15.1 Duty of Auditor to Inquire on certain matters (Implied Assumptions of Audit)

- Whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are prejudicial to the interests of the company or its members
- Whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company
- Where the company not being an investment company or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company;

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- Whether loans and advances made by the company have been shown as deposits
- Whether personal expenses have been charged to revenue account
- Where it is stated in the books and documents of the company that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.

15.2 Duty to Sign the Audit Report

As per section 145 of the Companies Act, 2013, the person appointed as an auditor of the company shall sign the auditor's report or sign or certify any other document of the company, in accordance with the provisions of section 141(2).
In case of an individual Chartered Accountant appointed, only the individual Chartered Accountant has a right and duty to sign the Audit Report
In case of a firm of Chartered Accountants appointed, any partner of the firm who is a practicing Chartered Accountant and not in employment elsewhere can sign the Audit Report.
If there are any qualifications mentioned in the Audit Report, it is to be readout in AGM.

15.3 Duty of Auditor to comply with Auditing Standards

As per section 143(9) of the Companies Act, 2013, every auditor shall comply with the auditing standards. Further, as per section 143(10) of the Act, the Central Government may prescribe the standards of auditing as recommended by the Institute of Chartered Accountants of India, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority.

15.4 Duty to Report

As per sub section 3 of section 143 of the Companies Act, 2013, the auditor's report shall also state –

- whether he has sought and **obtained all the information and explanations** which to the best of his knowledge and belief were necessary for the purpose of his audit and if not, the details thereof and the effect of such information on the financial statements;
- whether, in his opinion, **proper books of account** as required by law have been kept by the company
- **returns** adequate for the purposes of his audit have been received from branches not visited by him, for branches audited by persons other than him.
- whether the company's **balance sheet and profit and loss account** dealt with in the report are in agreement with the books of account and returns.
- whether, in his opinion, the financial statements **comply with the accounting standards**.
- the observations or comments of the auditors on financial transactions or matters which have any **adverse effect** on the functioning of the company.
- whether any **director is disqualified** from being appointed as a director u/s 164(2).
- any qualification, reservation or adverse remark relating to the **maintenance of accounts** and other related matters.
- whether the company has adequate **internal financial controls system** in place and the operating

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effectiveness of such controls.

- However, it may be noted that the reporting requirement on adequacy of internal financial controls (IFCs) with reference to financial statements shall not be applicable to a private company which is a
    a. One person company; or
    b. Small company; or
    c. Company having turnover less than 50 crore as per latest audited financial statement and having aggregate borrowings from banks or financial institutions or any body corporate at any point of time during the financial year less than 25 crore.
- Such other matters as may be prescribed. Rule 11 of the Companies (Audit and Auditors) Rules, 2014 prescribes the other matters to be included in auditor's report. The auditor's report shall also include their views and comments on the following matters, namely-
    - whether the company has disclosed the impact, if any, of **pending litigations** on its financial position in its financial statement.
    - whether the company has made provision, as required under any law or accounting standards, for material **foreseeable losses**, if any, on long term contracts including derivative contracts.
    - whether there has been any delay in transferring amounts, required to be transferred, to the **Investor Education and Protection Fund** by the company.

Section 146 requires auditor to attend AGM either in person or through representative unless exempted by the Company.

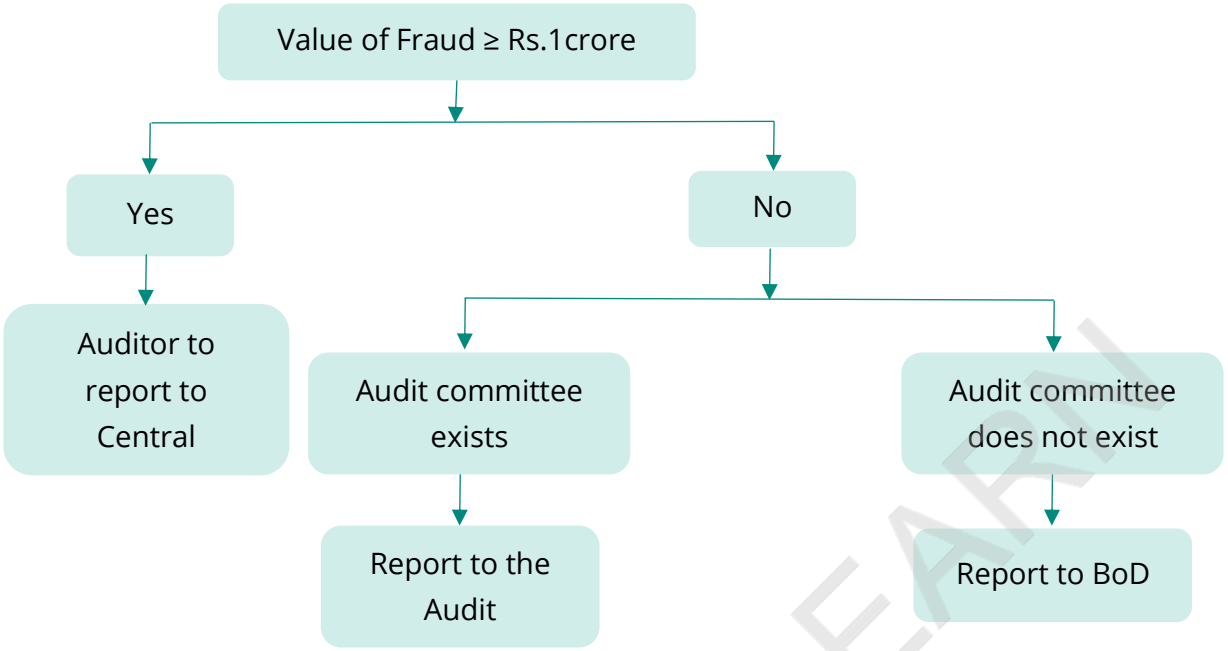
[Notes: (1) Students may note that the auditor is also required to report on certain additional matters specified under CARO, 2020 which is discussed later under Para 10 Reporting under Companies (Auditor's Report) Order, 2020.

(2) Students are also required to refer Guidance note on Reporting under section 143(3)(f) and (h) of the Companies Act, 2013.)

Further, in case of government companies and companies controlled by government, the Comptroller and auditor general of India shall direct the auditor of such companies the manner in which accounts of such companies are required to be audited. The copy of such report shall be submitted to the Comptroller and auditor general of India. It is to be further noted that Comptroller and auditor general of India has a right to conduct supplementary audit of financial statements of such companies within 60 days of receipt of audit report.

15.5 Duty to report fraud

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Report to Central Government in sealed cover in form ADT 4 within 60 days of his knowledge of fraud after following this procedure.

- Send a report in this regard to BOD / Audit Committee and seek reply ≤ 45 days.
- Upon receipt of such reply, send report of auditor along with replies to CG ≤ 15 days of receipt of reply.
- If no reply is received in 45 day's time, send a report to CG indicating this fact.
- Penalty for failure to follow this procedure is ≥ Rs.1L to ≤ Rs.25L
- BoD should give a detailed note in the "Director's Report" about the fraud.
- Auditor has to report in CARO about the fraud.

15.6 Duty to report on any other matter specified by Central Government.

National Financial Reporting Authority (NFRA) can ask the Auditor to verify and report on any particular issue related to company in case of suspicion.

15.7 Duty to state the reason for qualification or negative report.

Auditor has to explain the reasons for negative opinion.

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Report on frauds		
Amount involved	**< Rs.1 crore**	**≥ Rs.1 crore**
Report to	Audit committee or BoD	Central Government
Details in report	Nature, persons involved, Amounts, Action taken	Nature, persons involved, Amounts, Action taken
Company' s responsibility	Disclosure in Board report	Company to reply to clarifications sought by Auditor within 45 days
Report within	Within 2 days to Audit Committee or BoD	Within 2 days to Audit Committee or BoD
		Within 15 days from the lapse of 45 days to Central Government

Case Study

Give your comments on the following:

Mr. X, a Director of M/s KP Private Ltd., is also a Director of another company viz., M/s GP Private Ltd., which has not filed the financial statements and annual return for last three years 2010-11 to 2012-13. Mr. X is of the opinion that he is not disqualified u/s 164(2) of the Companies Act, 2013, and auditor should not mention disqualification remark in his audit report.

Answer:

Disqualification of a Director under section 164(2) of the Companies Act, 2013:

Section 143(3)(g) of the Companies Act, 2013 imposes a specific duty on the auditor to report whether any director is disqualified from being appointed as director under section 164(2) of the Companies Act, 2013.

As per provisions of Section 164(2), if a director is already holding a directorship of a company which has not filed the financial statements or annual returns for

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auditors for the immediately preceding three years and the said joint auditors are not re-appointed.

Answer:

a) *Appointment of a Practicing CA as 'Tax Consultant': A chartered accountant appointed as an auditor of a company, should ensure the independence in respect of his appointment as an auditor, else it would amount to "misconduct" under the Chartered Accountants Act, 1949 read with Guidance Note on Independence of Auditors.*

In this case, Mr. Aditya is a "Tax Consultant" and not a "Statutory Auditor" or "Tax Auditor" of ABC Ltd., hence he is not subject to the above requirements.

b) *Appointment of Sole Auditor: When one of the joint auditors of the previous years is considered for ratification by the members as the sole auditor for the next year, it is similar to non-re-appointment of one of the retiring joint auditors.*

As per sub- section 4 of section 140 of the Companies Act, 2013, special notice shall be required for a resolution at an annual general meeting appointing as auditor a person other than a retiring auditor, or providing expressly that a retiring auditor shall not be re-appointed, except where the retiring auditor has completed a consecutive tenure of five years or, as the case may be, ten years, as provided under sub-section (2) of section 139 of the said Act. Accordingly, provisions of the Companies Act, 2013 to be complied with are as under:

- *Ascertain that special notice u/s 140(2) of the Companies Act, 2013 was received by the company from such number of members holding not less than one percent of total voting power or holding shares on which an aggregate sum of not less than five lakh rupees has been paid up on the date of the notice not earlier than three months but at least 14 days before the AGM date as per Section 115 of the Companies Act, 2013 read with rule 23(1) and 23(2) of the Companies (Management and Administration) Rules, 2014.*
- *Check whether the said notice has been sent to all the members at least 7 days before the date of the AGM as per Section 115 of the Companies Act, 2013 read with rule 23(3) of the Companies (Management and Administration) Rules, 2014.*
- *Verify the notice contains an express intention of a member for proposing the resolution for appointing a sole auditor in place of both the joint auditors who retire at the meeting but are eligible for re-appointment.*
- *The notice is also sent to the retiring auditor as per Section 140(4)(ii) of the Companies Act, 2013.*
- *Verify whether any representation, received from the retiring auditor was sent to the members of the company.*
- *Verify from the minutes book whether the representation received from the retiring joint auditor was considered at the AGM.*

16. Companies (Auditor's Report) ORDER, 2020

16.1 Applicability of the CARO – 2020

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Every report made by the auditor under section 143 of the 2013 Act for financial year commencing on or after 1 April 2014 should include CARO – 2020.

16.2 Companies covered under the CARO – 2020

Applies to **every company** (except companies that are excluded, see below), including a foreign company as defined under section 2(42) of the 2013 Act i.e. any company or body corporate incorporated outside India which:

- has a place of business in India whether by itself or through an agent, physically or through an electronic mode, and
- conducts any business activity in India in any other manner.

16.3 Companies excluded from caro application

- **Banking company** as defined under section 5(c) of the Banking Regulation Act, 1949
- **Insurance company** as defined under the Insurance Act,1938.
- Companies licensed to operate under **section 8** of The Companies Act, 2013
- **Private company (other than holding or subsidiary of a public company)**:
  - with a ***paid-up capital and ****reserves not more than ***Rs. 1 crore*** and

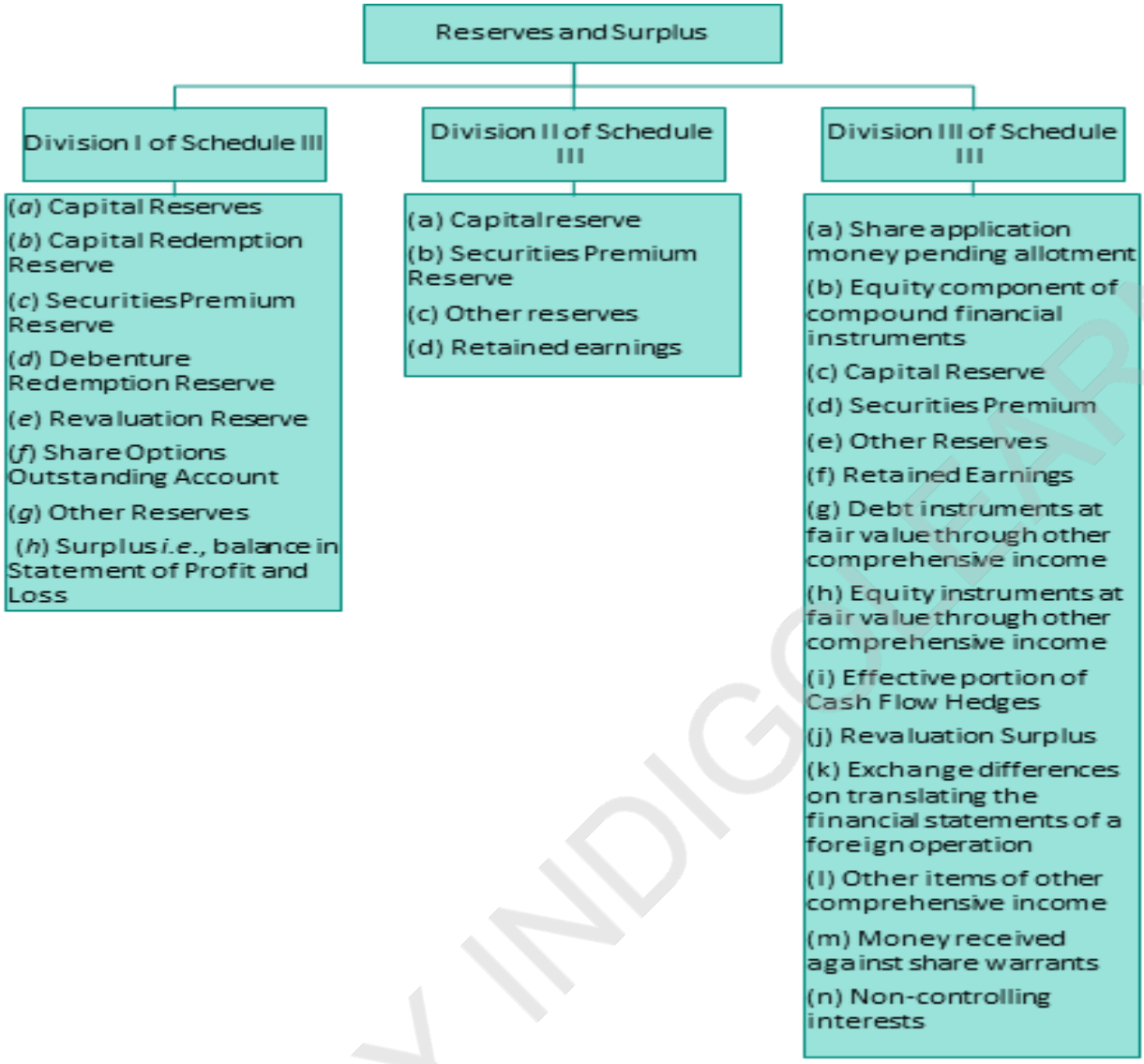
If an auditor or audit firm who or which has been performing any non-audit services on or before the commencement of the Companies Act, 2013, shall comply with the provisions of this section (i.e. section 144) before the closure of the first financial year after the date of such commencement.

Inclusions in paid-up capital	Exclusions from paid-up capital
Called and Received amount	Unpaid calls
Paid amount on forfeited shares	Advance share capital money received
Convertible instruments value is considered only once the actual shares are issued by the company	

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**

- does not have outstanding loan exceeding ***Rs. 1 crore*** from any bank or financial institution, and



- does not have a turnover exceeding ***Rs. 10 crores*** at any point of time during the financial year

- **One-person company** as defined under section 2(62) of the 2013 Act i.e. a company which has only one person as a member
- **Small company** as defined under section 2(85) of the 2013 Act i.e. a company other than a public company.

Following companies will **not qualify as a small company:**

- a holding or a subsidiary company,
- a company registered under section 8 of 2013 Act, or
- a company or body corporate governed by any special Act.

17. Matters to be reported in CARO

- When Auditor's response to any of the reporting matters is **UNFAVOURABLE/QUALIFIED**, the auditor should state the reason for such response.

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- When Auditor is unable to express any opinion in response to a particular question, the audit report should indicate such fact together with the reasons why it was not possible to provide a response to such a question.

Clause (i) - Fixed assets	• Whether the company is ***maintaining proper records*** showing full particulars, including ***quantitative details*** and situation of fixed assets. • Whether these fixed assets have been ***physically verified by the management at reasonable intervals***; Whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account. • Whether the ***title deeds of immovable properties*** are held in the name of the company. • Whether any proceedings have been initiated or are pending against the company for ***holding any benami property under the Benami Transactions (Prohibition) Act, 1988.***
Clause (ii) - Inventories	• Whether ***physical verification of inventory*** has been conducted at ***reasonable intervals*** by the management. • Whether any ***material discrepancies*** were noticed on physical verification, and if so, whether the same have been properly dealt with in the books of account.
Clause (iii) - Granting of loans to certain parties	• Whether the ***company has granted any loans,*** secured or unsecured to companies, firms or other ***parties covered in the register maintained under section 189 of the 2013 Act. If so:*** ▪ whether the ***terms and conditions*** of the grant of such loans are ***not prejudicial*** to the company's interest. ▪ whether the ***schedule of repayment*** of principal and payment of interest has

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	been stipulated and whether the repayments or receipts are regular. • If the amount is overdue, state the total amount ***overdue for more than 90 days*** and whether ***reasonable steps*** have been taken by the company for recovery of principal and interest.
Clause (iv) - Loans, investments, guarantees	In respect of loans, investments, guarantees, and security whether provisions of section 185 and 186 of the Companies Act, 2013 have been complied with. If not, provide the details thereof.
Clause (v) - Acceptance of deposits	• In case the company has accepted deposits, whether ▪ the directives issued by the Reserve Bank of India and ▪ the provisions of sections 73 to 76 or ▪ any other relevant provisions of the Companies Act, 2013 and the rules framed there under, where applicable, have been complied with. • If not, the nature of such contraventions be stated. • If an order has been passed by Company Law Board or National Company Law Tribunal or Reserve Bank of India or any court or any other tribunal, whether the same has been complied with or not.
Clause (vi) - Maintenance of cost records	• Where maintenance of cost records • has been specified by the Central Government • under section 148(1) of the 2013 Act, and • whether such accounts and records have been made and maintained.
Clause (vii) - Deposit of statutory dues	• ***Whether the company is regular in depositing undisputed statutory dues*** including provident fund, income-tax, wealth tax, duty of customs, value added tax, employees' state insurance, sales-tax, service tax, duty of excise, cess and any other statutory due with the appropriate authorities and ***if not, the extent of the arrears of outstanding statutory dues*** as at

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	the last day of the financial year ***concerned for a period of more than six months from the date, they became payable,*** shall be indicated by the auditor. • Where dues of income tax or GST (sales tax or service tax or duty of customs or duty of excise or value added tax) have ***not been deposited on account of any dispute,*** then the **amounts involved and the forum where dispute is pending shall be mentioned.** (A mere representation to the concerned department shall not constitute a dispute).
Clause (viii) – Unrecorded Income	• Whether any transactions ***not recorded*** in the books of account have been ***surrendered or disclosed as income*** during the year in the tax assessments under the Income Tax Act, 1961 (43 of 1961), if so, whether the previously unrecorded income has been properly recorded in the books of account during the year.
Clause (ix) - Default in repayment of dues	• Whether the company has defaulted in repayment of dues to a financial institution or bank or debenture holders? • If yes, the period and amount of default to be reported. (in case of defaults to banks, financial institutions, and Government, lender wise details to be provided).
Clause (x) - Application of money raised through public issue	• Whether ***moneys raised*** by way of initial public offer or further public offer ***(including debt instruments) and term loans*** were ***applied for the purposes*** for which those are raised. • whether the company has made any ***preferential allotment or private placement of shares or convertible debentures*** and if so, whether the requirements of ***section 42 and section 62*** of the Companies Act, 2013 have been complied with. • If not, provide ***details together with delays***

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	or default and subsequent rectification, if any, as may be applicable, be reported.
Clause (xi) - Fraud reporting	• Whether any ***fraud by the company or on the Company*** by its ***officers or employees*** has been noticed or reported during the year? If yes, the ***nature and the amount*** involved is to be indicated. • whether any report under ***section 143(12)*** of the Companies Act has been filed by the auditors in ***Form ADT-4*** with the Central Government • whether the auditor has considered ***whistle-blower complaints***, if any, received during the year by the company
Clause (xii) – Nidhi companies	• Whether the Nidhi Company has complied with the ***Net Owned Funds to Deposits in the ratio of 1:20*** • whether the Nidhi Company is maintaining ***10% unencumbered term deposits*** as specified in the Nidhi Rules, 2014 • whether there has been any default in payment of interest on deposits or repayment thereof for any period and if so, the details thereof.
Clause (xiii) – Related Parties transactions	• whether all transactions with the related parties are in compliance with ***sections 177 and 188*** of Companies Act, 2013. • whether the details have been disclosed in the Financial Statements etc., as required by the ***applicable accounting standards.***
Clause (xiv) – Internal Audit system	• whether the company has an internal audit system commensurate with the size and nature of its business • whether the ***reports of the Internal Auditors*** for the period under audit were ***considered by the statutory auditor.***

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Clause (xv) - Non-Cash Transactions between Company & Directors	• Whether the company has entered into any ***non-cash transactions*** with ***directors or persons connected with him*** and if so, whether the provisions of ***section 192*** of Companies Act, 2013 have been complied with.
Clause (xvi) - Registration under RBI Act for NBFC's	• Whether the company is required to be registered under ***Section 45-IA*** of the Reserve Bank of India Act, 1934 and if so, whether the registration has been obtained. • whether the company has conducted any ***Non-Banking Financial or Housing Finance activities without a valid Certificate of Registration (CoR)*** from the Reserve Bank of India • whether the company is a ***Core Investment Company (CIC)*** as defined in the regulations made by the Reserve Bank of India, if so, whether it continues to fulfil the criteria of a CIC, and in case the company is an exempted or unregistered CIC, whether it continues to fulfil such criteria
Clause (xvii) – Cash losses	• whether the company has incurred cash losses in the financial year and in the immediately preceding financial year, if so, state the ***amount of cash losses***
Clause (xviii) – Resignation of statutory auditors	• whether there has been any resignation of the statutory auditors during the year, if so, whether the auditor has taken into consideration the ***issues, objections or concerns raised by the outgoing auditors***
Clause (xix) – Material uncertainty on meeting liabilities	• On the basis of the financial ratios, ageing and expected dates of realization of financial assets and payment of financial liabilities, other information accompanying the financial statements, the auditor's knowledge of the Board of Directors and management plans

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	• whether the auditor is of the opinion that ***no material uncertainty exists as on the date of the audit report*** that company is capable of meeting its liabilities existing at the date of balance sheet as and when they fall due within a period of one year from the balance sheet date
Clause (xx) – Transfer of fund specified under Schedule VII	• whether, in respect of other than ongoing projects, the company has transferred unspent amount to a Fund specified in ***Schedule VII to the Companies Act within a period of 6 months*** of the expiry of the financial year in compliance with second proviso of ***section 135(5)*** of the said Act • whether any amount remaining unspent under section 135(5) of the Companies Act, pursuant to any ongoing project, has been transferred to special account in compliance with the ***provision of section 135(6)*** of the said Act
Clause (xxi) – Qualifications or adverse auditor remarks	• whether there have been any qualifications or adverse remarks by the respective auditors in the Companies (Auditor's Report) Order (CARO) reports of the companies included in the consolidated financial statements, if yes, indicate the ***details of the companies and the paragraph numbers*** of the CARO report containing the qualifications or adverse remarks.

CARO, 2020 v/s CARO, 2016 [Replacements]		
Clause	**Reporting under CARO, 2020**	**Reporting under CARO, 2016**
(i)(a)	Reporting on maintenance of proper records of ***Property, Plant, Equipment and Intangible Assets.***	Reporting on maintenance of proper records of ***Fixed Assets***.
(i)(b)	Reporting on Physical verification of ***Property, Plant, Equipment and Intangible Assets.***	Reporting on Physical verification of ***Fixed Assets.***

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(ii)(a)	Reporting on Physical verification of ***Inventory, its coverage and procedure, its disclosure if discrepancy is 10% or more in aggregate for each class of inventory***	Reporting on Physical verification of ***Inventory.***
(iii)	Reporting of ***Investments in, provided any guarantee or security or granted any loans or advances.***	Reporting of ***grant of any loans or advances, secured or unsecured.***
(v)	Reporting in respect of deposits or deemed to be deposits ***which are accepted by the Company***, as per provisions of Section 73 to 76 of the Companies Act, 2013 or any other relevant provisions	Reporting in respect of deposits accepted by the Company, as per provisions of Section 73 to 76 of the Companies Act, 2013 or any other relevant provisions.
(viii)	***Reporting on disclosure of transactions that not recorded in the books but have been surrendered or disclosed as income in tax assessments***	***Reporting on default in repayment of loans or borrowings. If yes, then amount and period of default to be reported.***
(ix)(a) & (ix)	***Reporting on default in repayment of loans or borrowings. If yes, then amount and period of default to be reported.***	***Reporting of moneys raised by way of IPO or further public offer and term loans, if any, were applied for the purpose for which they were intended.***
(x)(a) & (x)	***Reporting of moneys raised by way of IPO or further public offer and term loans, if any, were applied for the purpose for which they were intended.***	***Reporting of any fraud by or on the company by its officers or employees, if yes, then amount and nature of the same.***
(xi)(a) & (xi)	***Reporting of any fraud by or on the company, if yes, then amount and nature of the same.***	***Whether managerial remuneration has been paid or provided in accordance with requisite approvals of Section 197 of the Companies Act, 2013***
(xiv)(a) & (xiv)	***Whether Internal Audit System is commensurate with the size and nature of the Company.***	***Whether any preferential allotment or private placement of shares or convertible debentures has been made, if yes, then compliance with relevant sections has been done or not***

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Additions in CARO, 2020	
(i)(d)	Reporting on Revaluation of Property, Plant, Equipment and Intangible Assets, if any, specify the change if more than 10%.
(i)(e)	Reporting on Disclosure of any Proceedings of Benami Property under Benami Transactions (Prohibition) Act, 1988.
(ii)(b)	Disclosure if sanction of working capital limits in excess of 5 Crores, in aggregate, from banks and financial institutions on the basis of security of current assets.
(iii)(e)	Specify the amount of any Renew or Extension or Fresh Loan granted to settle the overdues of existing loans given to same parties.
(iii)(f)	Reporting of any loan granted which are repayable on demand or without specifying any terms or period of payment.
(ix)(b)	Reporting whether company is declared willful defaulter by any bank or financial institution or other lender.
(ix)(c)	Reporting whether term loans were applied for the purpose intended.
(ix)(d)	Reporting whether funds raised for short term have been utilized for long term purpose, if yes, then amount and nature of the same.
(ix)(e)	Reporting on whether the company has taken any funds from any entity or person on account of or to meet obligations of its subsidiaries, joint ventures or associates, if yes, then amount and nature of the same.
(ix)(f)	Reporting on whether the company has raised loans on the pledge of securities held in its subsidiaries, joint ventures and associates, if yes, then give details and also report any default in repayment, if any.
(x)(b)	Whether any preferential allotment or private placement of shares or convertible debentures has been made, if yes, then compliance with relevant sections has been done or not.
(xi)(b)	Whether any report under sub-section (12) of section 143 of the Companies Act, 2013 has been filed by the auditors in Form ADT-4.
(xi)(c)	Whether auditor has considered whistle- blower complaints, if any.
(xii)(c)	Whether there has been any default in payment of interest on deposits or repayment thereof for any period, if any, then details thereof.
(xiv)(b)	Whether reports of Internal Auditors were considered by the Statutory Auditor.
(xvi)(b)	Whether any non-banking financial or housing finance activities without a valid certificate of registration from RBI has been made.
(xvi)(c)	Whether the Company is a Core Investment Company (CIC), if yes, whether it fulfils the criteria of CIC
(xvi)(d)	Whether the group has more than 1 CIC as part of the group, if yes, then indicate the numbers of CIC's.
(xvii)	Whether the company has incurred any cash losses in the F.Y., if yes, then its amount.

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(xviii)	Whether there has been any resignation of statutory auditors during the year, if any, whether the auditor has taken into consideration the issues, objections or concerns raised by the outgoing auditors.
(xix)	Whether On the basis of financial ratios, ageing and expected dates of realization of financial assets and payment of financial liabilities. Whether the auditor is of the opinion that no material uncertainty exists as on the date of audit report
(xx)(a)	Whether in respect of other than ongoing projects, the company has transferred unspent amount to a fund specified in Schedule VII to the Companies Act, 2013 within a period of 6 months of the expiry of F.Y
(xx)(b)	Whether any amount remaining unspent has been transferred to special account
(xxi)	Whether there have been any qualifications or adverse remarks by the auditors in the CARO reports of the companies included in the CFS, if yes, indicate the details of the companies and the para nos. of the CARO report.

18. Disclosure in the Auditor's Report

18.1 AS-1 – Disclosure of Accounting Policies

- In the case of a company, Auditor should qualify the audit reports in case of –
  - accounting policies required to be disclosed under Schedule III or any other provisions of the Companies Act, 2013 have not been disclosed, or
  - accounts have not been prepared on accrual basis, or
  - the fundamental accounting assumption of going concern has not been followed and this fact has not been disclosed in the financial statements, or
  - proper disclosures regarding changes in the accounting policies have not been made.
- If the Disclosures are not made by management in the Notes to Accounts, Auditor should suitably change audit opinion to reflect the non-disclosures.

Exemption from AS

- Auditor should ***give note in Auditor's Report regarding exemption*** from applicability from certain accounting standards, granted by Central government in specific circumstances.

19. Joint Auditor

Joint audit basically implies pooling together the resources and expertise of more than one firm of auditors to render an expert job in a given time period which may be difficult to accomplish acting individually.

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In specific terms the advantages that flow may be the following:

Advantages	• Sharing of expertise. • Advantage of mutual consultation. • Lower workload. • Better quality of performance. • Improved service to the client. • Displacement of the auditor of the company taken over in a take - over often obviated. • In respect of multi-national companies, the work can be spread using the expertise of the local firms which are in a better position to deal with detailed work and the local laws and regulations. • Lower staff development costs. • Lower costs to carry out the work. • A sense of healthy competition towards a better performance.
Disadvantages	• The fees being shared. • Psychological problem where firms of different standing are associated in the joint audit. • General superiority complexes of some auditors. • Problems of co-ordination of the work. • Areas of work of common concern being neglected. • Uncertainty about the liability for the work done.

All the joint auditors shall be jointly and severally responsible for:

- the audit work which is not divided among the joint auditors and is carried out by all joint auditors.
- decisions taken by all the joint auditors under audit planning in respect of common audit areas.
- matters which are brought to the notice of the joint auditors by any one of them and there is an agreement among the joint auditors on such matters.
- examining that the financial statements of the entity comply with the requirements of the relevant statutes.
- presentation and disclosure of the financial statements as required by the applicable financial reporting framework.
- ensuring that the audit report complies with the requirements of the relevant statutes, applicable Standards on Auditing and other relevant pronouncements issued by ICAI.

In case 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 judgment by other joint auditors, the said joint auditor shall communicate the same to all the other joint auditors in writing prior to the completion of the audit.

It may be noted that the joint auditors are required to issue common audit report. However, where the joint auditors are in disagreement with regard to the opinion or any matters to be covered by the audit

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report, they shall express their opinion in a separate audit report. In such circumstances, the audit report(s) issued by the joint auditor(s) shall make a reference to each other's audit report(s).

20. Branch Auditor

- ***Branch Auditor is appointed by***
  - Appointed by members in AGM
  - May be delegated to BoD
  - BoD may consult with Principal Auditor and appoint Branch Auditors.

- ***Branch Auditor's Report***
  - Branch Audit report should be given to Principal Auditor
  - Principal Auditor will consider the same in his report.

- ***Books of Accounts of Branch***
  - Electronic/ Physical books maintained at Branch/HO
  - If placed at location other than Registered office, prior BoD approval required.

Where the branch office is situated in a country outside India, the accounts of the branch office shall be audited either by the company's auditor or by an accountant or by any other person duly qualified to act as an auditor of the accounts of the branch office in accordance with the laws of that country and the duties and powers of the company' s auditor with reference to the audit of the branch and the branch auditor, if any, shall be such as may be prescribed: It may be noted that the branch auditor shall prepare a report on the accounts of the branch examined by him and send it to the auditor of the company who shall deal with it in his report in such manner as he considers necessary.

Further as per rule 12 of the Companies (Audit and Auditors) Rules, 2014, the branch auditor shall submit his report to the company's auditor and reporting of fraud by the auditor shall also extend to such branch auditor to the extent it relates to the concerned branch.

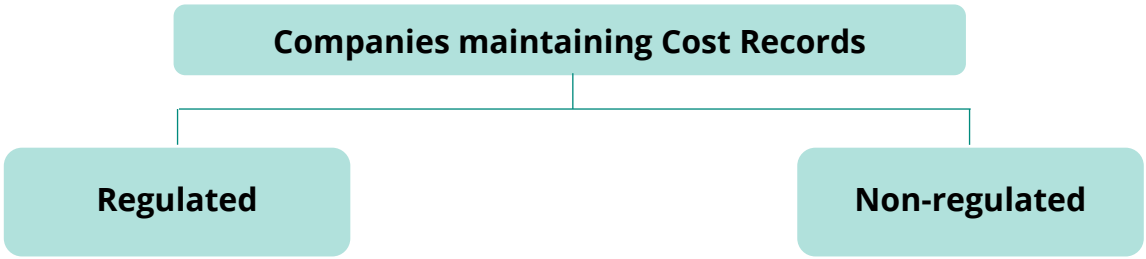
21. Cost Audit

Cost Audit is an audit process for verifying the cost of manufacture or production of any article, on the basis of accounts as regards utilisation of material or labour or other items of costs, maintained by the company. It is covered by Section 148 of the Companies Act, 2013. The audit conducted under this section shall be in addition to the audit conducted under section 143.

21.1 Maintenance of Cost Records

- Companies listed under Rule 3 of Companies Cost Records & Audit rules, 2014.
  - Companies with turnover > Rs.35 crores
  - Micro, Small and Medium Enterprises (MSME's) are exempt.

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- Rule 5 – Cost records for the Company (including branches) needs to be maintained under form CRA-1.
- Cost records should be maintained in such way that one can compute
  - Cost of production
  - Cost of sales
  - Margin on sales

  On monthly, quarterly, half-yearly or yearly basis.
- Under Clause (vi) of CARO, Statutory Auditor has to comment
  - Where maintenance of cost records
  - Has been specified by the Central Government
  - Under sub-section (1) of Section 148 of the Companies Act, 2013 and whether the Cost Records have been maintained accordingly.

21.2 Applicability of Cost Audit

Rule 4 of the Companies (Cost Records and Audit) Rules, 2014 states the provisions related to the applicability of cost audit depending on the turnover of the company as follows-

- Classes of companies specified under item (A) "Regulated Sectors" are required to get its cost records audited if the overall annual turnover of the company from all its products and services during the immediately preceding financial year is Rs.50 crore or more and the aggregate turnover of the individual product(s) or service(s) for which cost records are required to be maintained under rule 3 is Rs.25 crore or more.
- Classes of companies specified under item (B) "Non-Regulated Sectors" are required to get its cost records audited if the overall annual turnover of the company from all its products and services during the immediately preceding financial year is Rs.100 crore or more and the aggregate turnover of the individual product(s) or service(s) for which cost records are required to be maintained under rule 3 is Rs.35 crore or more.

21.3 Who can be Cost Auditor?

The audit shall be conducted by a Cost Accountant who shall be appointed by the Board of such remuneration as may be determined by the members in such manner as may be prescribed. It may be noted that no person appointed under section 139 as an auditor of the company shall be appointed for conducting the audit of cost records. It may also be noted that the auditor conducting the cost audit shall comply with the cost auditing standards ("cost auditing standards" mean such standards as are issued by the Institute of Cost Accountants of India, constituted under the Cost and Works Accountants Act, 1959, with the approval of the Central Government).

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21.4 Appointment of Cost Auditor

Rule 6 of the Companies (Cost Records and Audit) Rules, 2014 requires the companies prescribed under the said Rules to appoint an Auditor within 180 days of the commencement of every financial year. However, before such appointment is made, the written consent of the cost auditor to such appointment and a certificate from him or it shall be obtained.

The certificate to be obtained from the cost auditor shall certify that the-

- the individual or the firm, as the case may be, is eligible for appointment and is not disqualified for appointment under the Companies Act, 2013, the Cost and Works Accountants Act, 1959 and the rules or regulations made thereunder;
- the individual or the firm, as the case may be, satisfies the criteria provided in section 141 of the Companies Act, 2013 so far as may be applicable;
- the proposed appointment is within the limits laid down by or under the authority of the Companies Act, 2013; and
- the list of proceedings against the cost auditor or audit firm or any partner of the audit firm pending with respect to professional matters of conduct, as disclosed in the certificate, is true and correct.

Every referred company shall inform the cost auditor concerned of his or its appointment as such and file a notice of such appointment with the Central Government within a period of 30 days of the Board meeting in which such appointment is made or within a period of 180 days of the commencement of the financial year, whichever is earlier, through electronic mode, in Form CRA-2, along with the fee as specified in Companies (Registration Offices and Fees) Rules, 2014. The cost auditor appointed as such shall continue in such capacity till the expiry of 180 days from the closure of the financial year or till, he submits the cost audit report, for the financial year for which he has been appointed.

21.5 Removal of Cost Auditor

The cost auditor may be removed from his office before the expiry of his term, through a board resolution after giving a reasonable opportunity of being heard to the cost auditor and recording the reasons for such removal in writing. It may be noted that the Form CRA-2 to be filed with the Central Government for intimating appointment of another cost auditor shall enclose the relevant Board Resolution to the effect. It may further be noted that the above provisions shall not prejudice the right of the cost auditor to resign from such office of the company.

21.6 Casual Vacancy in the Office of a Cost Auditor

Any casual vacancy in the office of a Cost Auditor, whether due to resignation, death or removal, shall be filled by the Board of Directors within 30 days of occurrence of such vacancy and the company shall inform the central government in Form CRA-2 within 30 days of such appointment of cost auditor.

21.7 Remuneration of Cost Auditor

As per rule 14 of the Companies (Audit and Auditors) Rules, 2014-

- in the case of companies which are required to constitute an audit committee-

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- the Board shall appoint an individual, who is a cost accountant, or a firm of cost accountants in practice, as cost auditor on the recommendations of the Audit committee, which shall also recommend remuneration for such cost auditor;
- the remuneration recommended by the Audit Committee under (i) shall be considered and approved by the Board of Directors and ratified subsequently by the shareholders;

- in the case of other companies which are not required to constitute an audit committee, the Board shall appoint an individual who is a cost accountant or a firm of cost accountants in practice as cost auditor and the remuneration of such cost auditor shall be ratified by shareholders subsequently.

21.8 Qualification, Disqualification, Rights, Duties and Obligations of Cost Auditor

The qualifications, disqualifications, rights, duties and obligations applicable to auditors under this Chapter shall, so far as may be applicable, apply to a cost auditor appointed under this section and it shall be the duty of the company to give all assistance and facilities to the cost auditor appointed under this section for auditing the cost records of the company.

22. Cost Audit Report

22.1 Submission of Cost Audit Report

22.1.1 To the Board of Directors of the Company

The cost auditor shall submit the cost audit report along with his reservations or qualifications or observations or suggestions, if any, in Form CRA-3. He shall forward his report to the Board of Directors of the company within a period of 180 days from the closure of the financial year to which the report relates and the Board of Directors shall consider and examine such report particularly any reservation or qualification contained therein.

22.1.2 *To the Central Government*

The company shall within 30 days from the date of receipt of a copy of the cost audit report prepared (in pursuance of a direction issued by Central Government) furnish the Central Government with such report along with full information and explanation on every reservation or qualification contained therein in Form CRA-4 in Extensible Business Reporting Language (XBRL) format in the manner as specified in the Companies (Filing of Documents and Forms in Extensible Business Reporting language) Rules, 2015 along with fees specified in the Companies (Registration Offices and Fees) Rules, 2014.

22.2 Duty to Report on Fraud

The provisions of section 143(12) of the Companies Act, 2013 and the relevant rules on duty to report on fraud shall apply mutatis mutandis to a cost auditor during performance of his functions under section 148 of the Act and these rules.

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22.3 Cost Audit Rules Not to Apply in Certain Cases

The requirement for cost audit under these rules shall not be applicable to a company which is covered under Rule 3, and,

- whose revenue from exports, in foreign exchange, exceeds 75% of its total revenue; or
- which is operating from a special economic zone or
- which is engaged in generation of electricity for captive consumption through Captive Generating Plant.

22.4 Penal Provisions in Case of Default

If any default is made in complying with the provisions of this section,

- the company and every officer of the company who is in default shall be punishable in the manner as provided in sub-section (1) of section 147
- Section 139 – 146 of the Companies Act, 2013
  - Penalty for Company – Minimum Rs.25,000 and maximum Rs.5 lakhs.
  - Penalty for Officers & Directors – Minimum Rs.10,000 and maximum Rs.1,00,000.
  - Penalty for Auditors -

Minimum Rs.25,000 and Maximum Rs.5 lakhs	Whichever is lower
4 times the remuneration of the auditor	

- If an auditor has contravened such provisions knowingly or wilfully with the intention to deceive the company or its shareholders or creditors or tax authorities, he shall be punishable with
  - Imprisonment up to 1 year
  - Penalty

Fine of minimum Rs.50,000 and maximum Rs.25 lakhs	Whichever is lower
8 times the remuneration of the auditor	

  - Compensate the loss incurred due to such violation.
  - In case Auditor is a partnership firm, all partners will be jointly and severally responsible.
- the cost auditor of the company who is in default shall be punishable in the manner as provided in sub-sections (2) to (4) of section 147.

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AUDIT OF ITEMS OF FINANCIAL STATEMENT

Contents

- Introduction
- Assertions- Income Statement and Balance Sheet
- Audit of Balance Sheet items
- Audit of Profit and Loss Account Items

1. Introduction

A financial statement audit is the examination of an entity's financial statements which consists of Balance Sheet, Profit & Loss Account, Cash Flow Statement, Notes to account and accompanying disclosures. The purpose of a financial statement audit is to **add credibility** to the reported financial position and performance of a business.

Each financial statement purports to present something as a whole in addition to its component details. For example, an income statement purports to present "the results of operations" a balance sheet purports to present "financial position".

The auditor's opinion is typically directed to these overall representations. But to formulate and offer an opinion on the overall truth of these statements he has first to inquire into the truth of many specific assertions that makes up each of these statements. Out of his individual judgements of these specific assertions he arrives at a judgement on the financial statement as a whole.

This chapter discusses the various audit procedures that an auditor can perform in order to verify the various assertions appearing in the financial statements.

ASSERTIONS

DEFINITION OF ASSERTION: It refers to the representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur.

In preparing financial statements, company's management makes various implicit or explicit claims (i.e. assertions) regarding:

- completeness;
- cut-off;
- existence/ occurrence;
- valuation/ measurement;
- rights and obligations; and
- presentation and disclosure

of Assets, Liabilities, Equity, Income, Expenses and Disclosures in accordance with the applicable accounting standards.

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EXAMPLE: If Company X's balance sheet shows Building with carrying amount of ` 50 lakh, the auditor shall assume that the management has claimed/ asserted that:

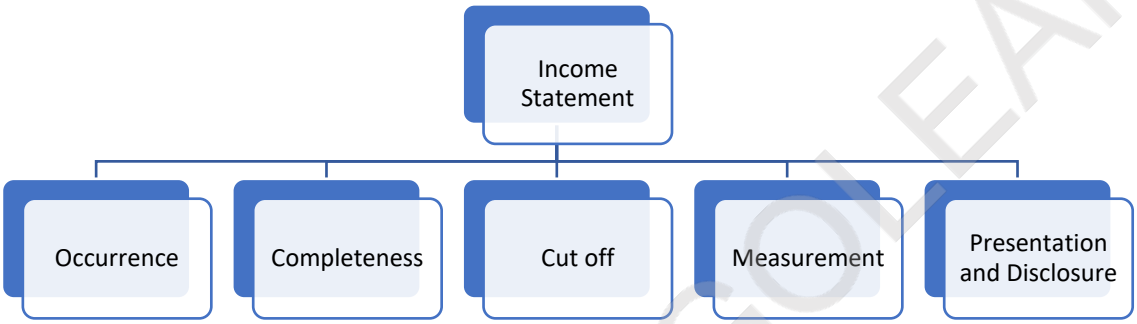
• The building recognized in the balance sheet exists as at the period- end (existence assertion);

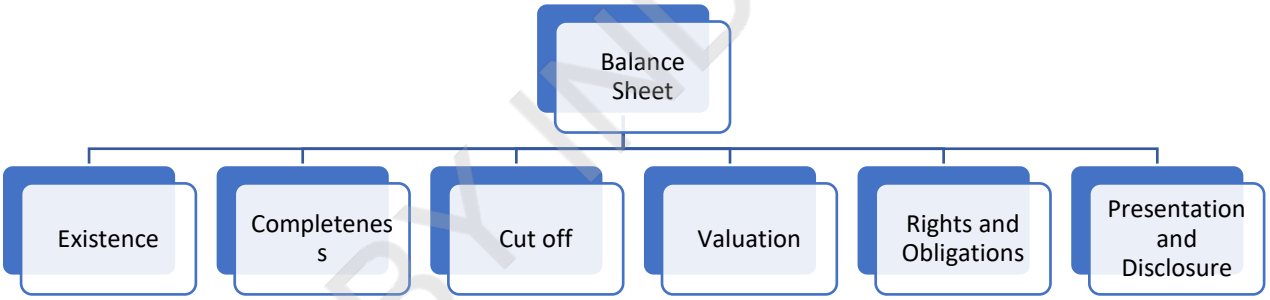
• Company X owns and controls such building (Rights and obligations assertion);

• The building has been valued accurately in accordance with the measurement principles (Valuation assertion);

• All buildings owned and controlled by Company X are included within the carrying amount of ` 50 lakh (Completeness assertion).

2. ASSERTIONS USED IN FINANCIAL STATEMENTS





3. Income Statement Assertions

Occurrence	Transactions recognized in the financial statements have occurred and relate to the entity.
Completeness	All transactions that were supposed to be recorded have been recognized in the financial statements. Transactions have not been omitted.
Cut off	Whether all income and expenses are reported in the- correct accounting period. Cut-off is a separate assertion because the substantive procedures to verify it are typically different from those applied to the other components of completeness

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Measurement	Transactions have been recorded accurately at their appropriate amounts in the financial statements. There have been no errors while preparing documents or in posting transactions to ledger. The figures and explanations are not misstated.
Presentation and Disclosure	Transactions have been classified and presented fairly in the financial statements. Transactions and events are appropriately segregated or disaggregated. Presentation and disclosure assertions are considered during the course of the audit to determine that the disclosures are complete and accurate.

4. Income Statement Assertions

Existence	Assets, liabilities and equity balances exist as at the period end.
Completeness	All assets, liabilities and equity balances that were supposed to be recorded have been recognized in the financial statements.
Cut off	Whether all assets and liabilities are reported in the appropriate period.
Valuation	Assets, liabilities and equity balances have been valued appropriately i.e. the amounts at which they are recorded are appropriate. There has been no overstatement or understatement
Rights and Obligations	Entity has the right to assets i.e. (whether the entity has ownership and legal title to assets) and the liabilities recognized in the financial statements represent all the entity's obligations to repayment as at a given date.
Presentations and Disclosure	Whether particular items in the financial statements are properly classified, described and disclosed. Presentation and disclosure assertions are considered during the course of the audit to determine that disclosures are complete and accurate

5. Audit of Share capital

Every company's lifecycle starts with raising of capital. The receipt of applications for shares and allotment of shares are two important aspects of every issue of capital as these constitute the legal basis of the transactions related to purchase of shares. Therefore, an auditor should be careful while doing the verification process.

Audit procedures while auditing share capital are as follows:

- ***Ledger A/c***

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- Tally the ***opening balance*** of share capitals to the previous year audited financial statements.
- Check the ***additions and deletions*** to share capital through fresh issue or bonus issue and reduction in the share capital.

- ***Test of Compliance with laws & regulations***
  - Check the provisions of companies Act regarding:
    - Whether the ***authorized Capital*** of the company is as per capital clause of Memorandum of association
    - Verify the terms related to ***fresh issue*** mentioned in the prospectus has been complied by the company.
    - Check the compliance of
      - Section 52- in case of shares issued at ***premium,***
      - Section 53 - when the shares are issued at ***discount,***
      - Section 54- in case of ***Sweat equity*** shares of the Companies Act.
    - Examine whether the provisions for ***forfeiture*** of shares are followed by the company.
    - In case of ***Reduction*** of capital verify whether board resolution has been passed along with a special resolution passed in the member meeting. Also verify that the memorandum of association of the company has been suitably **altered**.
  - Check the Registrar of companies (RoC) provisions regarding-
    - Whether form PS 3 & PS 4 is filed with RoC
    - Whether FCGPR form is filed with RBI (**in case of foreign shareholders).**
    - Check whether fee for the increase in authorized capital is paid to Registrar of company.

- ***Test of Controls***
  - Check whether the compliance officer has followed appropriate procedures for issuing shares.
  - Ascertain that there exists an internal check on receipt of amounts along with the application and that the same throughout has continued to function satisfactorily**.**

- ***Analytical Procedure***
  - Check whether the ***Stamp duty*** paid is in accordance to the increase in authorized capital.
  - Apply analytical procedures for ***share premium*** provisions**.**

- ***Test of Details***

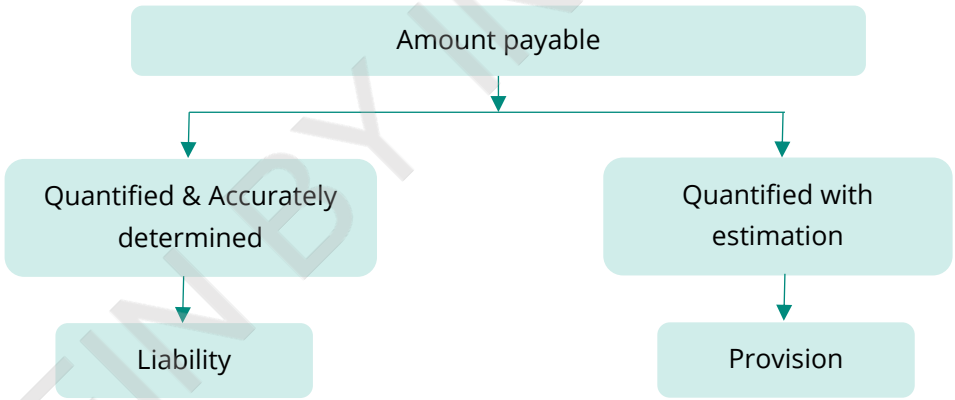
Assertions	Audit Procedures
Existence	Check the forms filed with Roc, Memorandum of company and bank statements in order to verify the existence of share capital.
Occurrence	• Check the **register of members** for allotment of shares. • Check the prospectus, bank statements, various forms etc.
Accuracy	Extract balances of shareholder's account contained in the share register and tally their total with the balance in the share capital.
Completeness	Check whether all the aspects related to **shares issues** have been properly accounted.

  - Verify the Following assertions

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Valuation	• Obtain a **written confirmation** from company secretary that there were no changes to entity's capital structure during the year. • In case there is change, obtain the **certified copies** of relevant resolution passed at the board meeting. • Verify whether the **paid-up capital** as at the period- end is within the limits of authorized capital.
Rights & Obligation	• Verify the board resolution for allotment. • Verify the share certificates and resisters of members.
Presentation & Disclosure	Ensure where the following disclosure as per Schedule III of the Companies Act, 2013 are made- • Whether **Authorized** capital, **Issued** and **subscribed** capital and **unpaid** capital are separately shown. • Whether the unpaid capital it should be shown as Calls in arrears. • Whether Shares issued in consideration **other than cash** are separately disclosed. • Disclosure for shares held in company by the following entities: ▪ Holding company ▪ Ultimate Holding company ▪ Subsidiaries of the Holding company ▪ Associates of the Holding company ▪ Subsidiaries of the Ultimate Holding company ▪ Associates of the Ultimate Holding company • Details of each shareholder (name, no of Shares & %) **with more than 5% stake.** **Above disclosure should have been made for a period of five years immediately preceding the balance sheet date**.

6. Audit of Reserves and Surplus



Reserves are the amount appropriated **out of the profits that are not intended to meet any liability, contingency, commitment, or diminution** in the value of asset known to exist as at the date of the balance sheet.

Provision is an amount that you put in aside in your accounts to cover a future liability. It is created as a **charge against the profit** which means it is created irrespective of the sufficiency of the profit.
Ex: - Provision for tax, Provision for doubtful debts etc.

Revenue reserve represents profits that are available for distribution to shareholders as dividends.	**Capital Reserve** represents a reserve which does not include any amount regarded as free for distribution through the statement of profit and loss.

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Share premium: When a company has issued its shares at **amount in excess of the nominal value of shares** it is called shares **issued at premium**. The company has to transfer the amount received through premium to security premium account. **The company can use this amount only for the purpose specified in section 52 of the Companies Act 2013.**

6.1 Securities Premium

Securities Premium reserve can be utilized for the following purposes

- Write off preliminary expenses
- Write off expenses related to issue of securities
- Premium on redemption of Debentures or redeemable Preference shares
- Issue fully paid up bonus shares
- Buy back of shares.

6.2 Audit procedures while auditing Reserves & Surplus

- ***Ledger A/c***
  - Tally the ***opening balance*** of reserves and surplus to the previous year audited financial statements.
  - Check for ***addition/utilization*** from the current year profit /loss Account and appropriation account if any.

Auditor's responsibility is not to ensure compliance but to check and report if management has complied with regulations or not.

- ***Compliance with laws and regulation***
  - Check the **minutes** of the board of directors and ensure that the profits are appropriated as per the decision taken by directors.
  - Verify whether the requirements of ***articles of association*** regarding the appropriation of profit to general or special reserves are duly followed by the company.
  - Check whether the management has complied with the required provisions of Companies Act while utilizing any part of the general reserve for **payment of dividend**.

- ***Test of Controls***
  - Check whether the required entries are duly **passed and approved** by competent authority.
  - Check whether the **board approval** is taken wherever required.

- ***Substantive analytical procedures***

  Substantive analytical procedures are applicable in case of only ***Capital redemption reserve.*** (CRR).
  - Check whether CRR is created only under following situations:
    - In case of redemption of preference shares the nominal value of the shares to be redeemed is put to capital redemption fund.
    - When a company buys its own shares.
    - In case of fresh issue of equity or preference share in order to redeem the old preference share, the difference between the face value of preference shares and fresh shares issued will be transferred to CRR.
  - Verify that this fund is utilized only for **issuing fully paid bonus shares**. No dividend is distributed out of this fund**.**
  - Check the ***calculation*** for the amount of CRR.

- ***Test of Details:***

  The following assertions needs to be verified

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Assertions	Audit Procedures
Occurrence	Check whether any additions/ utilization to /from the reserve and surplus have actually occurred.
Completeness	Verify that the reserve and surplus balances that were supposed to be recorded have been recognized in the financial statements.
Valuation	Check whether the provisions regarding dividend declaration and share premium have been complied.
Presentation & Disclosure	Ensure the disclosure requirements under part I of Schedule III to the Companies act has been made regarding • Opening balances, additions, Deduction & closing balances of the reserves and surplus. • **Reserve and Surplus shall be classified as:** ▪ Capital Reserves ▪ Capital Redemption Reserve ▪ Securities Premium Reserve ▪ Debenture Redemption Reserve ▪ Revaluation Reserve ▪ Share Options Outstanding Account ▪ Other Reserves – (specify the nature, amount, and purpose of each reserve) 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).

7. Audit of Loans and Long-term Borrowings

Liabilities are the financial obligations of an enterprise other than owner's fund. Liabilities include loans/ borrowings, trade payables and other current liabilities.
Verification of the loans and borrowings will be done as follows:

- ***Ledger A/c***
  - Check the ***opening balance*** with the previous year's audited closing balances.
  - Check any ***addition or deletion*** to Loan (i.e. any loan taken or repaid).

- ***Test of Compliance***
  - Whether the company is authorized to raise the loans as per its ***Memorandum.***
  - Whether the **board approval** is there by passing the board resolution for loan. (check the minutes of board meeting)
  - Wherever necessary the **member's approval** is taken in the general meeting.
  - There is compliance of **section 180, section 185 and 186** of the Companies Act on the borrowings of company.
  - In case of ***foreign currency loan*** whether compliance with RBI requirement is there.

- ***Test of Controls***
  - Check whether the loan documents are **signed** by competent authority.
  - Check whether there is proper utilization of loan. **Short term borrowings cannot be used for long term borrowings.**

- ***Substantive analytical procedures***

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- Check the **computation of interest** on loan by using substantive procedures.
- Examine relevant records and documentation supporting the validity and accuracy of loans.

- ***Test of Details: -*** Verify the following Assertions

Assertions	Audit Procedures
Existence occurrence and Accuracy	• Confirm loans and borrowings outstanding and interest payable on them by obtaining direct confirmation from the lender. • Examine the **loan agreement** for rate of interest and other terms of loan. Verify that borrowing limits imposed by agreements are not exceeded. • Examine **reconciliation** of the book balances with statement of lenders. • Agree details of lease and hire purchase creditors recorded to underlying agreement. • Check the **arithmetic correctness** of the loan amount.
Completeness	• Verify that the total amount of loan amount has been reflected in the financial statements. • Obtain a **schedule** of short term and long-term borrowing showing beginning and ending balances and repayments during the year.
Valuation	• Agree loan balance and loan payables to loan agreement. • Check **computation of the amortization** of premium or discount. • For foreign currency loans, agree the closing exchange rates used and test the translation calculations.
Rights and Obligations	• Examine documents evidencing any charge created in respect of loans and advances. Specially examine the requirements of the applicable statue regarding creation and registration of charges. • Verify that the **secured loans are shown separately**. Where the **market value** of an asset offered as a security against loan has fallen below the amount of loan outstanding ensure that the loan is classified **as secured only to the extent of market value of security. (**Details of the securities should be mentioned). • Check balances are confirmed by **external sources. (SA-505)**
Cut off	• Check whether the interest payable as on balance sheet is accounted appropriately. • Ensure whether the closing balance of the loan is same as balance confirmation
Presentation and Disclosure	• Examine whether the instalments of long-term loans falling due within **next twelve months** have been disclosed in the balance sheet as a **footnote**. • Ensure whether the following disclosures required under Companies Act under the heading of long-term borrowings have been complied with: ▪ Sub –classification as, Non-Current and Current Loan, secured and unsecured, Rupee loan and Forex loan. ▪ For secured borrowings, **nature of security** separately disclosed. ▪ Where loans are **guaranteed by directors or others** are separately disclosed. • For **default** in repayment of borrowing or interest on the balance sheet date disclosure regarding Period & Amount of should be made.

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Audit of Trade Receivables/Sundry Debtors

Trade receivables are an essential part of any organization's balance sheet. These are monies which are owned to an organization by a customer. Ex: - sales made on credit.

In order to check the authenticity for receivables following procedures should be performed by Auditor: -

- ***Ledger A/c***
  - Check the ***opening balance*** with the previous period's audited closing balances.
  - Check ***additions & deletions*** – Credit sales, Amount recovered & Bad Debts.

- ***Test of Controls***
  - Check whether there are controls in place to ensure that invoices cannot be recorded more than once.
  - Ensure that all the invoices are **accounted and approved** by the authorized person.

- ***Substantive Analytical Procedures***
  Auditor should make comparison of:
  - Current year ***ageing*** schedule with that of the previous year.
  - Significant ratio and trends pertaining to debtors.
  - Budgeted figures with actual figures.
  - Closing balances of current year with those of previous year.
  - Other ratios and analytical procedures relevant and applicable to the enterprise.

- ***Test of Details***
  Verify the following Assertions:

Assertions	Audit Procedures
Existence	• Check Invoices, Bank Statements & obtain Balance Confirmation to ensure that the trade receivable exists. • Follow up all the **balance disagreements and non –replies** to the receivables' confirmation.
Occurrence	• Obtain a **schedule of debtors** duly signed by responsible officer and examine it with reference to individual debtors account. • Inspect underlying documents (such as invoice, credit memos etc.).
Accuracy	Ensure whether the balances shown in the ledger accounts are consistent with balances as per control accounts.

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Completeness	• Ensure all sales, cash receipts and sales adjustment transactions occurred during the period have been recorded. • Ensure accounts receivables includes all claims on customers at the balance sheet date.
Valuation	• Assess the **allowance** for doubtful accounts. Review the process followed by the company to derive an allowance for doubtful debts. • Scrutinize and identity those debts which appear **doubtful**, discuss with management their reasons if any of these debts are not included in the provision for bad debts. • Assess bad debt write-offs. • Prepare schedule of movements on bad debts, provision accounts and debts written off and compare the proportion of bad debt expense to sales for the current year in comparison to prior years.
Rights and Obligation	• Check through balance confirmation whether the amount is receivable to the company. • Debtor as a charge for working capital loan should be disclosed.
Cut Off	• Verify the **year-end transactions and balances** to ensure whether the cut –off procedures are appropriately followed.
Presentation and Disclosure	• Check that the **restatement of foreign currency** trade receivables has been done properly. • Verify that the split between **more than 6 months and less than 6 months** has been done from the **due date instead of sales invoice date.** • Check that the classification of the amount due is properly disclosed as: ▪ Secured ▪ Unsecured ▪ Doubtful • Verify that proper disclosure has made for the amounts due from ▪ Directors or Other officers of the company ▪ By firms ▪ By private companies in which any director is a partner or director or member. • Ensure all the transactions with related parties are properly reported in CARO.

Audit of Cash & Cash Equivalents

Cash and Cash equivalent in the form of cash in hand, balances held with bank in current accounts/margin money accounts, fixed deposits, cheques in hand etc. represent the most liquid asset of an enterprise. Utmost professional skepticism needs to be exercised while auditing such balances.

7.1 Audit of Cash balances

- ***Ledger A/c***
  - Check the ***opening balance*** with the previous period's audited closing balances.
  - Check the ***inflows and outflows*** of cash during the year.

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- ***Test of Compliance***
  Check whether cash payments are **under the limit of income tax act**.

- ***Test of Controls***
  - Check whether Cash is handled by responsible officer.
  - Ensure that cashier should not make entries in the books of accounts.
  - Carry out ***surprise verification*** of cash during the year particularly when the entity is consistently maintaining unduly large cash balance.

- ***Test of Details***

Assertions	Audit Procedures
Existence	• Carry out a physical verification of cash in hand at the end of the year • Carry out surprise checks anytime during the year. • Examine all items of Cash Balance like Main cash balance, petty cash balance, imprest cash with employees etc., simultaneously.
Occurrence	• Examine the Cash Vouchers and Cash Book. • Examine all the other supporting documents such as cash receipts.
Accuracy	Verify mathematical accuracy of recorded cash balance • Trace total to the general ledger and to year end bank reconciliations prepared by the client. • Test cash on hand, as necessary.
Completeness	• Obtain and review or prepare year-end bank reconciliation. • Obtain a bank cut-off statement directly from the bank to ascertain whether the items on the year –end reconciliation have cleared from the bank and therefore were valid.
Valuation	The auditor should ensure that all bank account holding **foreign currency have been restated at the closing exchange rates.**
Rights and Obligation	Verify ownership of cash by carrying out simultaneous physical verification of cash at multiple locations to prevent fraudulent entry for cash.
Cut off	• Check whether the inflows and outflows are accounted in the relevant accounting period.
Presentation & Disclosure	• Ensure disclosure of cash in the financial statements as per recognized practices and relevant statutory requirements. • Ensure that **temporary advances given are not classified under Cash balances.** • If **postage and revenue stamps** exist in a substantial manner towards the year end, they should be **shown separately and not included in the Cash in Hand**.

7.2 Audit of Bank Balances

A cash certificate should be prepared on the verification date, which should be signed both by the auditor and cashier, each retain a copy of the same.

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Following Audit Procedures are required to verify the bank balances: -

- ***Ledger A/c***
  Check the ***opening balance*** with the previous year audited financial statements and the deposits and withdrawals during the year

- ***Test of Compliance of Laws & Regulations***
  Check whether the provisions of ***Negotiable Instruments Act*** regulation and RBI regulations wherever required are duly complied.

- ***Test of control***
  - Authorisation for opening, operating, and closing bank accounts
  - BRS prepared regularly & verified.

Assertions	Audit Procedures
Verify Existence, Occurrence, Completeness, accuracy, and valuation.	• Compare the entries in the ledger of the client with entries in cash book/bank statement. • Examine fixed deposit receipts and bank advises for verification of fixed deposits made. • Cash in transit should be verified with reference to their subsequent credit in bank account. • In case of stale cheques, the auditor should ensure suitable adjustments have been made in books of account. • Examine the bank reconciliation statement to ascertain the differences. • Verify the total number of bank accounts maintained by the entity. **New account opening requires Board resolutions**. Hence verify the same. • Obtain balance confirmation from the banker. • In case of foreign currency account conversions rates should be checked.
Rights & Obligations	• Bank accounts to be in the name of Company & check for Lien.
Cut-off procedures	• Check for year-end (pre & post) transactions. Check BRS.

- ***Presentation and Disclosures for Cash and Cash Equivalents***
  Ensure whether the following disclosures as required under Ind AS compliant Schedule III to Companies Act, 2013 have been made:
  - Cash and Cash equivalents shall be classified as:
    - Balance with banks
    - Cheques, drafts on hand
    - Cash on hand
    - Others (specify nature)
  - Earmarked balances with banks (for example, for unpaid dividend) shall be separately stated.
  - Balances with banks to the extent held as **margin money or security against the borrowings, guarantees, other commitments** shall be disclosed separately.
  - ***Repatriation restrictions,*** if any, in respect of cash and bank balances shall be separately stated.
  - Bank deposits with **more than 12 months** maturity shall be disclosed separately.

8. Audit of Inventories

Inventories are the tangible property held for **-**

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- Sale in the ordinary course of business or
- in the process of production for such sale or
- For consumption in the production of goods or services for sale**.**

Verification for inventories will be done as follows:

- ***Ledger Account***
  - Check the ***opening balance*** of inventory with the previous year's audited closing balance.
  - Check for the ***purchases and issue*** of inventory during the year through stock registers.
- ***Test of Compliance***

  Check for the compliance of ***AS-2 (valuation of inventories)*** for the following:
  - Recording inventory movement
  - Valuation of inventory issued
  - Valuation of closing balance. (**Cost or Net realizable value whichever is less).**
- ***Test of controls***
  - Ensure inventory **custody & issues** are done by authorized person.
  - Verify **stores and other material ledgers** including purchase, issue and closing balance.
  - Review the instructions for **stock take** and physically attend the stock take.
  - Ensure whether the **stock records** are updated by the management on continuous basis.
- ***Analytical procedures***

  Conduct analytical procedures for: -
  - Quantitative reconciliation of input-output
  - Previous year Vs. Current year comparison
  - Ratio Analysis
  - Comparison with industry standards and budgets.
- ***Test of Details - Verify***

Assertions	Audit Procedures
Existence	• Conduct the physical verification of inventories to check: - ▪ Existence of inventory ▪ Condition of inventory. • **Management is responsible for the physical verification of inventory;** auditor has to verify whether management has conducted the same. • Ensure the **method of physical verification** is fool proof (tag to floor and floor to tag) • Ensure the physical verification sheets are signed by both management and auditor. • **Pick samples randomly** to ensure all items and aspects for verification are covered. • Ensure **outside party stocks are not included** in the company's inventory list. • Physical verification should be done at the **end of the financial year.**
Occurrence	Check Delivery challans and gate passes, and goods received notes, bin card details etc. to check whether transaction has actually been occurred.
Accuracy	• Verify the clerical and arithmetical accuracy of inventory listings. • Reconcile physical counts (FIFO or Weighted average) with general ledger control total.

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Completeness	• Examine non- financial information related to inventory, such as weights and measures. • With respect to **tagged** inventory, perform tests for omitted transactions and test for invalid transactions.
Valuation	• Examine the method adopted by the management for inventory valuation (FIFO**, LIFO, or weighted average system)** • Ensure that the valuation of inventory is as per **AS-2** and the **condition of inventory** is recognized in their valuation.
Rights & obligation	• Vouch recorded purchases to underlying documentation. (purchase requisition, purchase order, vendor invoice • Evaluate the consigned goods. Examine client correspondence, sales and receivables records, purchase documents. • Review consignment agreements. • Examine invoices for evidence of ownership • Obtain a **declaration from the third party duly signed** by the authorized personnel in case inventory is held by third party confirming that the inventory belongs to the entity and is held by the third party on behalf of the entity.
Cut Off	• Check invoices, gate passes, delivery challahs, GRN's etc. • Perform purchase and sale cut- off tests. Trace shipping documents (bill of lading and receiving reports, inventory records) to inventory records immediately **before and after year-end**.
Presentation and Disclosure	Ensure whether the following disclosures as required under In AS compliant Schedule III to companies Act, 2013 have been made- • Whether **mode of valuation** has been stated separately for each class of inventory. • Whether inventory has been classified as- ▪ Raw materials ▪ Work-in –progress ▪ Finished goods ▪ Stock in trade ▪ Stores and spares ▪ Loose tools ▪ Others (specify nature) • Whether **goods in transit** have been disclosed separately under each sub-head of inventory

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9. Audit of Fixed Assets

Fixed assets may be defined as an asset

- which is held with the intention that it will be used for **the production or provisions of goods and services and**
- not for sale in the **normal course of business** and
- Such use shall have the potential to give **future economic benefits** to the enterprise.

Fixed asset can be further classified as Tangible Fixed Assets and Intangible Fixed Assets.

Fixed Assets Tangible includes Land, Building, Plant & Equipment, Furniture & Fixture, Vehicles, Office Equipment, and Computers etc.

For the audit of Tangible Fixed Asset, we need to understand the difference between **Revenue Expenditure and Capital Expenditure**.

- ***Revenue Expenditure***

An expenditure, the benefits of which shall be exhausted in the process of earning revenue within a short span of time, **maximum period being one year** are classified under Revenue Expenditure. **Revenue expenditure are charged to P/L Account** Example: - Cost of raw material and stores consumed in the process of manufacture/ production, Rent, rates and taxes, Power and Fuel, Repairs, maintenance and renewals of fixed Assets, Legal and professional charges etc.

- ***Capital Expenditure***

An expenditure incurred for the following purpose will be classified under capital expenditure -

- Acquiring fixed assets, which are held not for resale but for the use within the business, whose benefits will last for multiple of accounting period.
- Making additions / enhancements to the existing fixed assets with the intent to increase earning capacity of the business.
- Minimizing the cost of production.

All such expenditures are added to the cost of assets.
Expenses which are essentially of revenue nature, if incurred for creating an asset or adding to its value for increasing productivity are also regarded as of Capital Nature.

9.1 Audit of Fixed Assets (Tangible)

- ***Ledger Account***
  - Check the ***opening balances*** of fixed assets with the previous year's audited closing balances.
  - Check any ***addition & deletion*** in the fixed assets account through the fixed asset register.
- ***Test of Compliance***
  - Check whether all the ***accounting standard*** related to fixed assets have been complied.
  - Verify whether the **board approvals** have been obtained for purchase of assets.
  - Check **Board & Members resolution** for major sale as per companies Act.
- ***Test of Control***
  - Check whether the purchase of fixed asset is made by the authorized person on behalf of the entity.
  - Physical verification is done regularly
- ***Substantive Analytical Procedures***
  Apply Substantive analytical procedures for **depreciation (SA 520**)

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- ***Test of Details***

Assertions	Audit Procedures
Existence	• Conduct **physical verification** of fixed assets. **Management is responsible for the physical verification of fixed assets**; auditor has to verify whether management has conducted the same. • Review **client's plan** for performing physical verification, whether done by own staff or third party and the interval for verification. • Verify the **discrepancies** noted based on physical verification and manner in which such discrepancies are dealt
Occurrence	In order to ensure that the fixed asset exists vouch all the supporting documents related to fixed assets such as, vendor invoices, purchase agreements, Sale deeds, RCs etc.
Accuracy	Verify the movement in the fixed assets schedule complied by the management i.e. Opening+ Additions- Deletions= closing and tally the closing balance to the entity's book of account.
Completeness	Ensure that all the incidental costs to acquisition of the assets are capitalized along with the asset.

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Valuation	• Ensure that the valuation of the fixed assets is done in line with the applicable accounting standards. • In order to arrive at the closing balance of assets, the **provision for depreciation** has followed (whether SLM or WDV). • Verify whether any asset damaged is written off.
Rights and Obligation	• Verify that all purchase invoices are in the **name of the entity** that entitles legal title to the ownership to the respective entity. • Obtain copies of conveyance deed/ sale deed for all the additions to land and building to ensure that the entity is the legal and valid owner. • Ensure that the **title deed** is in the custody of owners. • In case of mortgage obtain a certificate from mortgagee or his lawyer confirming the possession of the title deed. • Also verify the register of charges, available with the entity to assess the fixed assets that has been **given as security to any third parties.**
Cut off	Check whether the transaction occurred during the period has been recorded in the current accounting period.
Presentation & Disclosure	Ensure whether the following disclosures as required under Ind AS compliant Schedule III to companies Act,2013 have been made: • Whether all items of property, plant and equipment have been classified as ▪ Land ▪ Buildings ▪ Plant and Equipment ▪ Furniture and fixtures ▪ Vehicles ▪ Office equipment ▪ Other (Specify nature) • Whether the entity has disclosed asset “under lease” both whether operating and finance lease separately under each class of asset. • For each class of property whether the entity has disclosed a reconciliation of the gross and net carrying amounts at the beginning and end of the reporting period showing separately: - ▪ Opening balance of gross carrying amount ▪ Additions ▪ Acquisitions through business combinations ▪ Disposals

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- Disposals through demergers
- Other adjustments (Borrowing cost capitalized)
- Closing balance of gross carrying amount.

- For each class of property, plant, and equipment, whether the entity has disclosed:
  - Opening accumulated depreciation
  - Charge for the year
  - Deduction/other adjustments for depreciation
  - Closing accumulated depreciation
- For each class of property, plant, and equipment, whether the entity has disclosed:
  - Opening accumulated impairment losses
  - Impairment losses
  - Impairment reversals
- Closing accumulated impairment losses.

9.2 Audit of Intangible Assets

Intangible assets are those assets: -

- Which do not have a physical identity but are used by the enterprise for production or supply of goods or for retails to other or for the purpose of administration.
- Such assets do not have physical existence but their presence in the business is pointed out with a value placed there on.
- These assets include the rights and benefits to the owners subject to their utility. For Ex: patent, copyright, trademark etc.

Goodwill internally generated is not recognized as an asset and not covered under AS 26.

Closing balance to be arrived after providing for depreciation appropriately for the period based on consistent policy (Valuation).
Auditor has to obtain legal opinion whenever required with respect to ownership related issues (Rights & Obligations).

Audit Procedures for the verification of Intangible Fixed asset are as follows: -

- ***Ledger Account***
  - Check the ***opening balances*** of intangible fixed assets with the previous year's audited closing balance.
  - ***Additions*** to intangible through internally generated or through amalgamations should be checked.
- ***Test of Compliance***
  - Check whether principles of **AS 26** are complied with which says that purchase of intangible asset should include stamp duty, legal charges etc. to arrive at the cost of intangible.
  - Check whether the internally generated intangible asset meets the ***criteria of recognition.*** In case of: -
    - ***Research phase: -*** No intangible asset arising from research shall be recognized. Expenditure on research shall be recognized **as an expense and charge off.**
    - ***Development phase-*** Expenditure incurred during this phase should be **capitalized if product is successful commercially** otherwise it should be charge off if conditions of AS -26 are not fulfilled.
  - See whether **board approval** has been taken for the purchase of intangible assets.
- ***Test of control***
  - Check whether authorized personnel has **approved and executed** purchase and sale of intangibles.

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- Verify if proper internal processes and procedures like inviting competitive quotations were followed prior to finalizing the vendor.

- ***Substantive Analytical procedures***
  - Check whether the entity has charged the **amortization** on all intangibles.
  - Verify that the amortization method used reflects the pattern in which the asset's future economic benefits are expected to be consumed by the entity.
  - Also verify that the management has undertaken an impairment assessment to determine whether an intangible asset is impaired.

- ***Test of details***

  Verify the following assertions in relation to intangibles: -

Assertions	Audit Procedures
Existence	• Verify documents related to asset. • Obtain confirmation letters from client's legal adviser as to the validity and existence of intangibles asset. (SA 620 work of an expert)
Occurrence	• Check the documents related to purchase of asset, bank statements, and board approvals. • If the assets have been transferred ensure whether the rights have been transferred related to assets.
Accuracy	• Ensure that all the components related to the cost of assets are taken into consideration for arithmetic accuracy Obtain list for all additions during the period under audit. And for all material additions verify if such expenditure meets recognition criteria. • Verify the movement in the intangible assets schedule complied by the management i.e. Opening+ Additions- Deletions= closing and tally the closing balance to the entity's book of account.
Completeness	Assess whether for an internally generated intangible asset meets the criteria for recognition, an entity classifies the generation of assets into: ➢ Research phase ➢ Development Phase
Valuation	• Verify that Amortization principle as per **AS 26** has been complied • Check that Impairment provisions has been followed as per **AS 28**
Rights and Obligation	Check various agreements and minutes of board meetings regarding Intangible Assets
Cut off	Ensure that accounting for the Intangible Assets is done by following the Periodicity concept of Accounting.

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Presentation & Disclosure	Ensure whether the following disclosure as required under Ind AS compliant Schedule III to Companies Act, 2013 have been made: - • **For Goodwill** whether the entity has disclosed a reconciliation of the gross and net carrying amounts at the beginning and end of the reporting period showing separately: - ▪ Opening balance of gross carrying amount ▪ Additions ▪ Disposals ▪ Impairments ▪ Other adjustments • Whether all items of **intangible assets** have been classified as: ▪ Brands/ Trademarks ▪ Computer Software ▪ Mining rights ▪ Copy rights and patents and other intellectual property rights, ▪ Licenses and franchise ▪ Of Other (specify nature) • **For each class of intangibles**, whether the entity has disclosed a reconciliation of the gross and net carrying amounts at the beginning and end of the reporting period showing separately: ▪ Opening balance of gross carrying amount ▪ Additions ▪ Acquisitions through business combinations ▪ Disposals ▪ Disposals through demergers ▪ Other adjustments ▪ Borrowing cost capitalized ▪ Closing balance of gross carrying amount. • For each class of intangibles, whether the entity has disclosed: - ▪ Opening accumulated amortization ▪ Charge for the year ▪ Deduction/ other adjustments for amortization ▪ Closing accumulated amortization • For each class of intangibles, whether the entity has disclosed: - • Opening accumulated impairment losses • Impairment losses • Impairment reversals • Closing accumulated impairment losses

The auditor must verify requirements required by CARO in respect of Fixed Assets.

10. Audit of Trade Payables and Other Current Liabilities

Liabilities in addition to borrowing include trade payables and other current liabilities. Trade payables are the liabilities owned to suppliers for purchases or services rendered. Verification of liabilities is important to ensure whether any liability is not understated or overstated.

Audit Procedures for the verification of trade payables are as follows: -

- ***Ledger Account***
  - Check the ***opening balances*** of Trade payables with the previous year's audited closing balances.

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- Check the expenses ***incurred and payment*** made during the year.

- ***Test of Compliance***

  Check whether all the requirements under **Micro, Small and Medium Enterprises Development Act, 2006 (MSME)** has been complied regarding the payments made to such parties having MSME registration.

- ***Test of Control***
  - Check whether the management has adequate internal control regarding recording of purchases, invoices are not recorded twice, purchases are for business purpose only.
  - Ensure whether the payments are **approved** by the authorized person.
  - Test checks few bills for payments made during the period.
  - Related party transactions to be verified carefully as **risk of fraud** are more.

- ***Substantive Analytical Procedures***

  Apply substantive procedures to calculate-
  - Creditor Turnover Ratio
  - Creditor to credit purchases
  - Average payment period

  Also obtain the list of vendors with whom company has disputes and any claims from customers, under litigation and compare with previous year

- ***Test of details***

Assertions	Audit Procedures
Existence	• Obtain Balance confirmation from Creditor. • Vouch Subsequent payments to the creditors.
Occurrence	• Inspect documents underlying purchases such as invoices receiving reports purchase order etc. and verify individual creditor's accounts balance against these documents. • Check the invoices raised by the vendors to the company. • Ensure there is no duplicate invoice.
Accuracy	Verify that the total of the creditor's balance in the schedule agrees with the balances of the total account relating to the bought ledger in the general ledger.
Completeness	• Verify whether all the transactions related to purchase & services received are accounted and there is no **unrecorded liability.** • Verify whether all the **statutory dues and consider CARO 2020 reporting requirement** are properly recorded in books of accounts.
Valuation	Assess the **old outstanding liability** balances-Review the process followed by the company to identity any creditors/ liability needs to be **written back**. • Match ledger balances with direct balance confirmations from the creditor and ensure that both are reconciled. • Perform subsequent period bank statement verification if there are no replies from the creditors for balance confirmation. • Check that the **restatement of foreign currency** trade payables has been done properly.
Rights and Obligation	Check the direct confirmation obtained by the creditors.
Cut off	Verify the balance confirmations obtained, BRS, Reconciliation for difference in balances to confirm that transaction occurred during the periods are recorded in the current period

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Presentation & Disclosure	Ensure whether the following disclosures as required under Ind AS compliant Schedule III to Companies Act, 2013 have been made: • Whether the Company has classified a payable as a trade payable if it is in respect of the amount due on account of goods sold or services rendered in the normal course of business. • Whether the Company has disclosed the following details relating to **micro enterprises and small enterprises** in the notes: ▪ **The principal amount and the interest due** thereon (to be shown separately) remaining **unpaid** to any supplier at the end of each accounting year. **The amount of interest paid by the buyer in terms of section 16** of the Micro, Small and Medium Enterprises Development Act, 2006, along with the amount of the payment made to the supplier beyond the appointed day during each accounting year. ▪ **The amount of interest due and payable for the period of delay** in making payment (which have been paid but beyond the appointed day during the year) but without adding the interest specified under the Micro, Small and Medium Enterprises Development Act, 2006. ▪ The amount of **interest accrued and remaining unpaid** at the end of each accounting year. ▪ The amount of further **interest remaining due and payable** even in the succeeding years, until such date when the interest dues above are actually paid to the small enterprise, for the purpose of disallowance of a deductible expenditure under section 23 of the Micro, Small and Medium Enterprises Development Act, 2006. • Whether the amount disclosed under other current liabilities are classified as below: ▪ Revenue received in advance ▪ Other advances (specify nature) ▪ Other current liabilities (specify nature) • He shall prepare a complete list of all statutory dues and consider his reporting requirements under CARO

11. Audit of Loans and Advances, Other Current Assets.

Loans means money advanced to related or other parties with or without interest while **advances** include amounts recoverable either in cash or in kind or for value to be received accrued interest, e.g., rates, taxes and insurance paid in advance/ prepaid.

Other current assets primarily include accrued interest on loans/ fixed deposits held, balances with statutory/ governments etc.

- ***Ledger A/c***
  - Check the ***opening balances*** of Loans & advances, with the previous year's audited closing balance.
  - Check the ***additions and deletions*** in the loans & advances and current assets.
- ***Test of Compliance***
  - Check whether any loans or advances granted is as per the ***Memorandum and Articles of Association.***
  - Inspect the ***minutes*** of meeting of board of directors to confirm if all material loans and advances were approved by board of directors.
  - In case of ***related party loans and advances*** check whether they are properly authorized, and the value of such transactions were reasonable. And whether provisions of companies act, and disclosure requirements of accounting standard are complied.
- ***Test of Controls***
  - Check whether loans given are approved by the **authorized person**.

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- Ensure that the securities against loans are **periodically reviewed**.
- All the documents related to loans and advances are in **safe custody**.

- ***Substantive Analytical Procedures***
  - If there are **interest on loans** carry out substantive audit procedures.
  - Obtain the list of loans and advances under **litigation** and compare with previous period.
  - Scrutinize and analyze those loans and advances that appear **doubtful** and discuss the reasons with management for the same.

- ***Test of Details***

Assertions	Audit Procedures
Existence	For establishing existence of loans and advances, account receivables obtain direct confirmation from the parties who receive that loan.
Occurrence	Verify the bank statements, loan agreement, and letter from statutory authority from deposits made.
Accuracy	Obtain list of all advances and other current assets and compare them with balances in the ledger
Completeness	• Check whether all the advances given have actually been recorded • Inspect loan agreements and acknowledgements of parties in respect of outstanding loans.
Valuation	• Assess the allowance for doubtful accounts. Review the process followed by the company to identity doubtful accounts needs to be written off. • Obtain ageing report of loans and advances, **split between current, less than 30 days old, 30-60 days old, 60 -180 days old, 180 -365 days old and more than 365 days old** • Check that the **restatement of foreign currency loans** and advances has been done properly.
Rights and Obligation	• Check that in the **loan deed** the name of the company exists. • In case of **deposits with statutory authorities**, name of the company should be existing.
Cut off	• Verify the balance confirmations obtained, BRS, Reconciliation for difference in balances to confirm that transaction occurred during the periods are recorded in the current period.
Presentation & Disclosure	Ensure whether the following disclosures as required under Ind AS compliant Schedule III to companies Act,2013 have been made: • Whether loans have been classified as: - ▪ Security deposits ▪ Loans to related parties (give details) ▪ Other loans (specify nature) • Whether all the above loans have been further classified as: - ▪ Secured ▪ Unsecured ▪ Doubtful • Whether allowance for bad and doubtful loans has been disclosed separately for each category of loans. • Check whether separate disclosure is made in case of loans due from: - ▪ Director(s) of the company ▪ Director(s) of the company jointly with other persons. ▪ Other Officer(s) of the company. ▪ Other Officer(s) of the company jointly with other persons. ▪ Firm(s) in which director is a partner.

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Presentation & Disclosure	• Other Current Assets. 1. Advances other than capital advances which are further sub – classified as: - ▪ Security Deposits ▪ Advances to related parties (give details) ▪ Other advances (specify nature) 2. Other current assets (specify nature) For advances, whether separate disclosure has been made for amounts due by: - ▪ Director(s) of the company ▪ Director(s) of the company jointly with other persons ▪ Other officer(s) of the company ▪ Other Officer(s) of the company jointly with other persons. ▪ Firm(s) in which director is a partner ▪ Private company (ies) in which director is a director or a member.

12. Audit of Provisions and contingent liabilities

12.1 Provision

- Provision is a **present obligation** of the entity arising from the past events,
- the settlement of which is expected to result in **an outflow** from the entity of resources embodying economic benefits.
- a **reliable estimate** cannot be made of the amount of obligation.

Example: - Provision for litigation, provision for warranties, provision for employee benefit expenses etc.

12.1.1 Audit Procedures for provisions

- Make the **best estimate** of the provision required using the given information.
  For this check: - records, agreements, legal cases etc.
- Use the **work of the expert** to ensure that provisions are reasonably made (SA 620). Example Actuary, Lawyer
- Check **reversals or additions** to provisions and the same are accounted for.
- Ensure the compliance of the applicable accounting standards. **Ex AS 29, AS 15.**
- Check the **legal register** to know the legal cases & disputes pending against the company. And also check & verify BOD minutes to know the updates for the same.
- Check expert opinions and computations.
- Ensure that the presentation & Disclosure as per Schedule III of the companies Act,2013 have been made: -
  - Whether Current/ Non-current provision is split.
  - Disclosure is made for each class of provision. (Opening balance & Closing balance)
  - Additional provision increased/ decreased this year.
  - Brief disclosure to be made for each class of asset, specifying

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- (Nature of obligation, expected timing of outflow of resources)
- Indication of uncertainties of amount and time of provisions.
- Amount of any expected disbursement.

12.2 Contingent Liability

Contingent liabilities refer to-

- Obligations relating to past transactions or other events or conditions that may or may not arise in future.
- The possibility of a contingent liability crystal ling into an actual liability thus depends upon happening/ non happening of an event.

Example- Pending litigation against the entity, discounted bills receivable, Guarantees of third-party obligations etc.

12.2.1 Audit Procedures to verify Contingent liabilities are as follows:-

- Obtain a **certificate** from the client that all known contingent liabilities have been included and properly disclosed in the financial statements.
- Review the **minutes of meeting** of board of directors to discover contingency commitments if any.
- Obtain **list of pending legal cases** and check the legal status of pending cases with help of experts.
- Assess the provision made or contingent liability disclosed, is in line with **AS 29**.
- Whether as per Schedule III of the companies Act,2013 disclosure in the notes to accounts in the following manner-
  - Whether Contingent Liability have been classified as-
    - Claims against the company not acknowledged as debt
    - Guarantees
    - Other money for which the company is contingently liable
  - Whether the amount of any guarantees given by the entity on behalf of the directors or other officers of the company has been stated.

13. Audit of Sale of Products and Services

Audit procedure

• Identify the control points over sales.

• Tests the identified controls to determine how strong and reliable they are. If controls are assessed as strong, the auditor can reduce the amount of substantive testing.

• Selects a random sample of transactions and examines the related customer purchase orders, invoices and customer statements.

• Performing substantive audit procedures like vouching and Substantive Analytical Procedure (SAP). SAP will consist of sales trend analysis, comparison of sales figures with previous accounting period etc.

• Verification of revenue may be carried out by employing the following procedures:

a) Examination of records;

b) Analytical review procedures.

Assertions to be evaluated

Occurrence

Ensure that sales recorded represent goods shipped/services performed during the period.

Completeness

Ensure that all sales made during the period were recorded and there in no understatement or overstatement.

Measurement

Ensure that all sales are accurately measured as per applicable accounting standards and correctly journalized, summarized, and posted.

Presentation and Disclosure

Ensure that required disclosures for sales have been appropriately made

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Audit procedure to establish Occurrence

1. To ensure that revenue is not overstated, auditor is required to perform the following audit procedures:

• Check whether a single sales invoice is recorded twice or a cancelled sales invoice could also be recorded.

• Test check few invoices with their relevant entries in sales journal.

• Obtain confirmation from few customers to ensure genuineness of sales transaction.

• Whether any fictitious customers and sales have been recorded.

• Whether any shipments were done without the consent and agreement of the customer, especially at the year end to inflate the sales figure.

• Whether unearned revenue recorded as earned.

• Whether any substantial uncertainty exists about collectability.

• Whether customer obligations are contingent on other actions (financing, resale, etc.).

2. Review sequence of sales invoices.

3. Review journal entries for unusual transactions.

4. Calculate the ratio of sales return to sales and compare it with previous year and enquire for the reasons for increase/decrease.

5. Check the sales return with sales invoice, challan, credit note, stock register, etc.

Audit procedure to establish Completeness

1. Perform cut-off procedures to ensure that revenues are recognized in the current accounting period and sales were not tampered towards the period end.

2. Cut-off errors, will usually arise when companies recognize revenue based on the date on which the sales invoices are generated rather than the date on which the risks and rewards are transferred to the buyer.

3. Verify the credit notes issued after the accounting period. Sometimes sales team or sales personnel can make fictitious sales before the year-end to meet performance target and cancel out those sales with a post year end credit note.

4. Trace from the shipping documents to the sales journal.

5. Check whether quantity is appearing in sales register or not and check reconciliation of total sales/goods dispatched as per stock records and financial records and statutory records like GST.

6. Review GST tax and GST returns and ensure that the same are reconciled with revenue reported in the profit and loss account.

Audit procedure to establish Measurement

1. Trace a few transactions from inception to completion. (Examination in depth)

E.g.: Take few sales transaction, and check from the receipt of sales order to the payment of receivable balance, every underlying document to ensure if it is properly recorded at every stage and measured accurately taking into consideration all the incentives, discounts, if any.

2. If the client is engaged in export sales, then compliance with AS 11 shall be ensured.

3. Auditor must understand client's operations and related GAAP issues e.g. point of sale revenue recognition vs. percentage of completion, wherever applicable.

4. Compare the rate of sales affected with related parties and review them for collectability, as well as whether they were properly authorized and the value of such transactions were reasonable and at arm's length.

Audit procedure in specific cases

Consignment sales

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1. Verify terms of agreement between consignor and consignee to ascertain terms & conditions regarding commission & other expenses.

2. Ensure that the goods consigned are not treated as ordinary sales.

3. Ensure that gross sale proceeds as mentioned in account Sales has been credited to Consignment a/c and debited to consignee's a/c.

4. Ascertain that credit has been taken only for profit on the goods sold through the consignee before the year end.

5. Ensure that stock lying with the consignee at the end should be taken in balance sheet at cost and credited to Consignment A/c to arrive at the result of the consignment transactions.

6. Obtain confirmation of balance from the consignee.

7. In case, goods are consigned at invoice price, ensure that the necessary adjustments to remove the loading have been made.

8. Examine the adjustments made at the year end in respect of the goods not yet sold, commission and the expense incurred by consignee.

Good Sent out on Sale or Return basis

a) Check maintenance of separate memoranda records of goods sent out on sale or return. Only after approval from customer, personal account of customer is debited and the sales account is credited.

b) Ensure that price of such goods is unloaded from the sales account and the debtor's record before the approval from customer.

c) In respect of goods for which approval period has expired, ensure that either goods have been received back or customer's account have been debited.

d) In respect of goods for which approval period has not expired till the close of the year and lying with the party, ensure that cost of such goods has been included in the closing stock.

Disclosure Requirements of Schedule III

Company shall disclose separately by way of notes on face of the Statement of Profit and Loss.

a) In respect of a company other than a finance company: Revenue from Operations Revenue from.

i. Sale of products
ii. Sale of services
iii. Other operating revenues
Less: Excise duty.

b) In respect of a finance company: Revenue from Operations Revenue from

i. Interest; and
ii. Other financial services.

c) Brokerage and discount on sales other than usual trade discount to be disclosed separately.

d) Transactions with related parties to be disclosed appropriately in notes to accounts.

14. Audit of other Incomes (interest, Dividend, Profit/Loss on sale of Investments etc.)

Recognition of Income

Interest on Fixed Deposits

Interest income on fixed deposits is recognized on a time proportion basis taking into account amount outstanding and the applicable interest rate.

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Dividend

Dividends are recognized in the statement of profit and loss only when:

i. the entity's right to receive payment of the dividend is established;
ii. it is probable that the economic benefits associated with the dividend will flow to the entity; and
iii. the amount of the dividend can be measured reliably.

Gain (Loss) on investments

Gain/ (loss) on sale of investment is recorded as other income on transfer of title from the entity and is determined as the difference between the redemption price and carrying value of the investments.

Assertions to be examined

Occurrence

Recorded other income was earned during the period.

Completeness

Other income earned during the period was appropriately recorded and there in no understatement or overstatement.

Measurement

Other income has been measured appropriately as per the applicable accounting standards.

Presentation and Disclosure

Required disclosures for other income have been appropriately made.

Audit Procedures - Interest on Fixed Deposits

• Obtain a list of all fixed deposits exist at the beginning of the year and newly made during the audit, along with applicable interest rate and the number of days for which the deposit was made.

•Verity arithmetical accuracy of interest calculation by multiplying the deposit amount with the applicable rate and number of days during the period under audit.

•For deposits outstanding as at the year end, obtain direct confirmation from the respective bank/ financial institution.

• Obtain a confirmation of interest income from the bank and verify that the interest income as per bank reconciles to the calculation shared by the entity.

• Obtain a copy of Form 26AS (TDS) and reconcile the interest reflected therein to the calculation shared by client.

Audit Procedures Dividend

Verify that the dividend is recognized in the statement of profit and loss only when the entity's right to receive payment of the dividend is established, provided it is probable that the economic benefits associated with the dividend will flow to the entity and the amount of the dividend can be measured reliably.

Audit Procedures Gain (Loss) on sale of investment in Mutual Funds

• Verify that Gain/(loss) on sale of investment in mutual funds is recognized as other income only on transfer of title from the entity and is determined as the difference between the redemption price and carrying value of the investments.

• Obtain the mutual fund statement and trace the gain/ loss as recorded in the books of account to the gain/loss as reflected in the statement.

Disclosure Requirements of Schedule III

Classification of Other Income

Other income shall be classified as:

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I.	Interest Income (except for a finance company)
II.	Dividend Income
III.	Net gain/loss on sale of Investments
IV.	Other Non-0perating Income (net of expenses directly attributable to such income)

Disclosure of Undisclosed Income

Company shall give details of any transaction not recorded in the books of account that has been surrendered or disclosed as income during the year in the tax assessments under the Income-tax Act, 1961 (such as, search or survey), unless there is immunity for disclosure under any scheme and also shall state whether the previously unrecorded income and related assets have been properly recorded in the books of account during the year.

15. Audit of Purchases

Audit Procedure

• Identify the control points over purchases.

• Tests the identified controls to determine how strong and reliable they are. If controls are assessed as strong, the auditor can reduce the amount of substantive testing.

• Selects a random sample of transactions and examines the related purchase orders, Goods received Note (GRN), purchase invoices, inward gate entry register and vendor reconciliation/ statements.

• Performing substantive audit procedures like vouching and Substantive Analytical Procedure (SAP). SAP will consist of purchase trend analysis, comparison of purchase figures with previous accounting period etc.

• Verification of revenue may be carried out by employing the following procedures:

a) Examination of records;

b) Analytical review procedures.

Assertions to be examined

Occurrence

Ensure all purchases recorded in books of account represent goods actually received/ services availed during the period.

Completeness

Ensure all purchases made during the period were recorded and there in no understatement or overstatement.

Measurement

Ensure all purchases have been measured appropriately.

Presentation and Disclosure

Ensure that required disclosures for purchases have been appropriately made.

Audit Procedure to establish Occurrence

Ensure purchases are not understated/overstated by performing following audit procedures:

1. Whether any fictitious vendors have been booked or purchases have been recorded by reviewing vendor selection process followed by the entity and also performing procedures to ensure existence of the vendors.

2. Whether the goods were received at the factory gate and whether there exists an entry in the security gate inward register.

3. Whether quality inspection of goods was done.

4. Whether a goods receipt note was prepared and signed by an appropriate client personnel.

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5. Whether the purchase invoice was approved as per delegation of authority.

6. Whether stock record has been updated by the store's personnel.

Special considerations during audit of purchases

1. Purchase invoice received should be the "Original" copy" against which the entity has recorded the purchase in its books of account.

2. Purchase invoice should have been booked only once risk and reward incidental to ownership has been transferred to the entity.

3. Purchase invoice should be in the name of entity.

4. Input tax component should have been booked in the input tax ledger.

5. In case of purchases made from related parties, verify if requisite approval from Board of Directors has been obtained and verify the selected samples and perform analytical procedures in relation to price of goods to confirm that price charged is at arm's length.

Audit Procedures to establish Completeness

1.Perform cut-off test to ensure that purchases are recognized in the correct accounting period. For the purpose, the auditor should examine material inward records, say, last 5 transactions at the period end to check that all corresponding invoices have been duly entered in the Purchases book and none have been omitted.

2. Ensure correct accounting treatment of goods-in-transit as per the agreed terms with the vendor regarding transfer of risk and reward of ownership in goods.

3. Obtain WR from the management that all the purchases that took place during the year have been properly recorded in the books.

4. Perform analytical procedures to obtain audit evidence as to overall reasonableness of purchase quantity and price.

Analytical Procedures

Analytical procedures to obtain audit evidence as to overall reasonableness of purchase quantity and price may include:

I.	**Consumption Analysis**: Examine consumption of raw material from manufacturing account and compare the same with previous years with closing stock and ask for the reasons from management for any significant variations noticed.
II.	**Stock Composition Analysis**: Collect reports from management for composition of stock i.e. raw materials as a percentage of total stock & compare the same with previous year and ask for reasons from management for any significant variations noticed.
III.	**Ratios:** Compare the creditor's turnover ratios and stock turnover ratios of the current year with previous years.
IV.	**Quantitative Reconciliation**: Review quantitative reconciliation of closing stocks with opening stock, purchases and consumption.

Disclosure Requirements of Schedule III

Ensure whether the following disclosures as required under Schedule III (Division 1) to Companies Act, 2013 have been made:

1. Whether purchases of stock-in-trade have been specifically disclosed.

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2. Whether changes in inventories of finished goods, stock-in-trade and work- in-progress have been specifically disclosed.

3. Whether the transactions with related parties are appropriately disclosed in notes to accounts.

16. Audit of Employee Benefit Expense

Obtaining understanding as to hiring, appraisal and retirement process

a) Tests the controls the entity has set around employee benefit payment process to determine how effective they are. If they are effective, auditor can reduce the substantive testing. Common internal controls include maintaining attendance records, employee master, authorization of monthly payroll processing and disbursement, computation of employee deductions like payroll taxes, accrual of other benefits like gratuity, leave encashment, bonus etc.

b) Auditor selects a random sample of transactions and examines the related appointment letters, appraisal letters, attendance records, HR policies, employee master etc.

c) Performing substantive audit procedures. Substantive analytical procedure will consist of monthly expense reasonability, comparison with previous accounting period, setting an expectation in relation to the expense incurred during the period under audit and compare that with the client's business operations and overall trend in the industry.

Assertions to be examined

Occurrence

Ensure employee benefit expenses recorded in books of account were actually incurred during the period.

Completeness

Ensure that employee benefit expenses pertaining to the period have been recorded appropriately and there in no understatement or overstatement.

Measurement

Ensure that employee benefit expenses have been measured appropriately.

Presentation and Disclosure

Ensure that required disclosures for employee benefit expenses have been appropriately made.

Audit Procedure

• Obtain an understanding of process of recording employee attendance.

• Obtain a list of employees along with a monthly movement split between new hires, leavers and continuing employees.

• In case of new employees, select few cases on random basis and obtain the appointment letter and verify whether the salary for first month and subsequent months was processed as per the agreed terms.

• In case of employees who resigned, select few cases on random basis and obtain their full and final computation and verify whether all their dues including post-retirement benefits like gratuity, leave encashment have been paid and whether the respective employee's acknowledgement on final computation has been obtained.

• Obtain the monthly salary registers for complete year. Compile a monthly payroll reasonability by calculating the average salary per employee per month and compare with the previous year and preceding month.

• Verify whether provision has been made for all employee benefits and obligations like bonus, gratuity, leave encashment.

• In case Provident Fund (PF), Employee State Insurance (ESI) are applicable to the entity. Determine a reasonable amount by applying the rate to the basic wages and comparing to the amount recorded in books and analyze reasons for variance, if any.

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• Perform analytical procedures to obtain audit evidence as to overall reasonableness of employee benefit expense.

Disclosure Requirements of Schedule III

Ensure whether employee benefit expense has been classified as:

• Salaries and Wages

• Contribution to Provident and Other Funds

• Expense on Employee Stock Option Scheme (ESOP) & Employee Stock Purchase Plan (ESPP)

• Staff Welfare Expenses

17. Audit of Depreciation and Amortisation

Attributes to be considered

Auditor needs to consider following attributes while verifying for depreciation and amortisation expenses:

- Obtain understanding of entity's accounting policy related to depreciation & amortization.
- Ensure the Company policy for charging depreciation and amortisation is as per the relevant provisions of Companies Act/applicable ASs.
- Accounting policy has been applied consistently. Change has been adequately disclosed.
- Whether depreciation has been calculated after making adjustment of residual value from cost of the assets.
- Whether depreciation and amortisation charges are valid.
- Whether depreciation and amortisation charges are accurately calculated and recorded.
- Whether all depreciation and amortisation charges are recorded in appropriate period.
- Ensure the parts (components) of each item of PPE that are to be depreciated separately.

Assertions to be examined

Occurrence

Recorded depreciation and amortisation expenses were actually incurred -during the period.

Completeness

Depreciation and amortisation expenses pertaining to the period have been recorded appropriately and there in no understatement/ Overstatement

Measurement

Depreciation and amortisation expenses have been measured appropriately.

Presentation and Disclosure

Required disclosures for depreciation and amotisation have been appropriately made.

Audit procedures

1. Obtain an understanding of entity's process of charging depreciation and amortization.

2. Obtain the fixed asset register maintained by the entity. Check the nature of asset from fixed asset register; physically verify the fixed assets, at least the ones that are material in value.

3. Select sample of assets from the Fixed Assets Register, on materiality considerations and verify the rates of depreciation and depreciation calculations.

4. Obtain the list of all the components identified by the management.

5. Ensure Intangible assets like patents, goodwill, copy rights have been properly amortized over the period.

6. Ensure depreciation is charged on the assets from the date when it is ready to use and not from the date of actual usage.

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7. Ensure depreciation on revalued amount has been properly accounted from revaluation reserve.

8. Perform analytical procedures to obtain audit evidence as to overall reasonableness of depreciation and amortisation expense.

9. Ensure that the depreciation and amortization has been charged as per the useful lives of PPE and intangible assets.

10. Ensure that residual values have been properly verified as that impacts the computation of depreciation.

Disclosure Requirements

Ensure whether the following disclosures as required have been made:

a) accounting policy for depreciation and amortization.
b) Useful lives of assets as per Schedule II to the Companies Act, 2013.
c) Residual value of assets.
d) Depreciation method.

18. Audit of Other Expenses (Power & Fuel, Rent, Repairs, Insurance, Travelling etc.)

Attributes to be examined while vouching Expenses

- Whether the expenditure pertained to current period under audit;
- Whether the expenditure qualified as a revenue and not capital expenditure;
- Whether the expenditure had a valid supporting documents like travel tickets, insurance policy, third party invoice etc.;
- Whether the expenditure has been classified under the correct expense head;
- Whether the expenditure was authorized as per the delegation of authority matrix;
- Whether the expenditure was in relation to entity's business & not a personal expenditure.

Assertions to be examined

Occurrence

Recorded other expenses were actually incurred during the period.

Completeness

Other expenses pertaining to the period have been recorded appropriately and there in no understatement or overstatement.

Measurement

Other expenses have been measured appropriately.

Presentation & Disclosure

Required disclosures for other expenses have been appropriately made.

Audit Procedures for Rent Expense

• Obtain a month wise schedule of rent payment along with the rent agreements.

• Examine whether rent expense has been recorded for all 12 months and whether the rent paid is as per the underlying agreement.

• Whether agreement contains any escalation clause, if yes, verify whether rent has been increased/adjusted during the period only as per escalation clause.

• Verify whether the agreement is in the name of the entity.

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• Verify whether expense pertains to premises used for running business operations.

Audit Procedures for Power and fuel expense

• Obtain a month wise expense schedule of payment along with the power bills.

• Examine whether the expenses have been recorded for all 12 months.

• Compile a month wise summary of power units consumed and applicable rate and check the arithmetical accuracy of the bill raised on monthly basis.

• Analyze monthly power units consumed by linking it to units of finished goods produced and investigate reasons for variance in monthly trends.

Audit Procedures for Insurance expense

• Obtain a summary of insurance policies taken along with their validity period.

• Verify whether expense has been correctly classified between prepaid and expense for the period based on number of days.

Audit Procedures for Legal and professional expenses

• Obtain a month wise and consultant wise summary.

• In case of monthly retainer ship agreements, verify whether expenditure for all 12 months has been recorded correctly.

• For non-recurring expenses, select a sample on random basis and vouch for the attributes.

• Special focus should be given while vouching for legal expenses as the same may highlight a dispute for which the entity may not have made any provision and the matter may also not have been discussed/highlighted to the auditor for his specific consideration.

Audit Procedures for Travel, Repair & Maintenance, Printing & stationery, Misc. expenses

• Select a sample on random basis and vouch for the occurrence, completeness, measurement and appropriate disclosure.

• Wherever possible, auditor should try and prepare a summary of expenditure on monthly basis and then analytically compare the trends.

• In addition, auditor should perform analytical procedures to obtain audit evidence as to overall reasonableness of other expense which may include expenditure per unit produced.

• Auditor should analyse expense per unit produced and compare the same with previous years and prevent industry trends and ask for the reasons from Management If any significant variations are found.

Disclosure Requirements

Ensure other expense have been classified under:

a) Rent
b) Insurance
c) Power and fuel
d) Repairs and maintenance -Building, Plant and machinery, others

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e) Legal and professional
f) Printing and stationary
g) Travel expenses
h) Miscellaneous expenses

0ther Miscellaneous Provisions

19. Disclosure of CSR activities

Where the company is covered u/s 135 of the Companies Act, 2013, following shall be disclosed with regard to CSR activities:

a) amount required to be spent by the company during the year,

b) amount of expenditure incurred,

c) shortfall at the end of the year,

d) total of previous years shortfall,

e) reason for shortfall,

f) nature of CSR activities,

g) details of related party transactions, e.g., contribution to a trust controlled by the company in relation to CSR expenditure as per relevant AS,

h) Where a provision is made with respect to a liability incurred by entering into a contractual obligation, movements in the provision during the year should be shown separately.

20. Details of Crypto Currency or Virtual Currency

Where the Company has traded or invested in Crypto currency or Virtual Currency during the financial year, the following shall be disclosed:

a) profit or loss on transactions involving Crypto currency or Virtual Currency,

b) amount of currency held as at the reporting date,

c) Deposits or advances from any person for the purpose of trading or investing in Crypto Currency/ virtual currency.

21. Details of Benami Property held

Where any proceedings have been initiated or pending against the company for holding any benami property under the Benami Transactions (Prohibition) Act, 1988 and the rules made thereunder, the company shall disclose the following:

a) Details of such property, including year of acquisition,

b) Amount thereof.

c) Details of Beneficiaries,

d) If property is in the books, then reference to the item in the Balance Sheet,

e) If property is not in the books, then the fact shall be stated with reasons,

f) Where there are proceedings against the company under this law as an abetter of the transaction or as the transferor then the details shall be provided,

g) Nature of proceedings, status of same and company's view on same.

22. Relationship with Struck off Companies

Where the company has any transactions with companies struck off u/s 248 of the Companies Act, 2013, Company shall disclose the following details:

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Name of struck off Company	Nature of transactions with struck off Company	Balance outstanding	Relationship with the Struck off company, if any, to be disclosed
	Investment in Securities		
	Receivables		
	Payables		
	Shares held by struck off company		
	Other outstanding balances (to be specified)		

23. Ratios

Following Ratios to be disclosed:

a) Current Ratio,
b) Debt-Equity Ratio,
c) Debt Service Coverage Ratio,
d) Return on Equity Ratio,
e) Inventory turnover ratio,
f) Trade Receivables turnover ratio,
g) Trade payables turnover ratio,
h) Net capital turnover ratio,
i) Net profit ratio,
j) Return on Capital employed,
k) Return on investment.

The company shall explain the items included in numerator and denominator for computing the above ratios. Further explanation shall be provided for any change in the ratio by more than 25% as compared to the preceding year.

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SPECIAL FEATURES OF AUDIT OF DIFFERENT TYPES OF ENTITIES

GOVERNMENT AUDIT

1. Introduction

- The concept, content and scope of government audit have developed in tune with the political, social and economic development of the countries.
- It has also responded to the needs of the administration. It aims to ensure accountability of the executive in respect of public revenue and expenditure.
- the Parliament and in case of States, the State legislatures control all government expenditure through insistence upon demand for grants.
- The main idea underlying this control is that no expenditure can be incurred unless it has been voted upon by the Parliament or State Legislatures and funds for every such expenditure must be provided from out of the Consolidated Fund of India or of the State.
- Parliamentary or Legislative control is exercised before spending and after the expenditure is actually incurred.

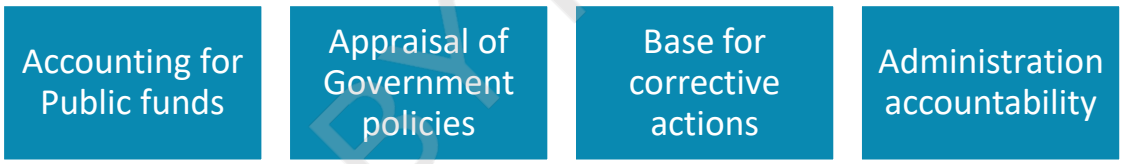
2. Meaning of Government Audit

Government auditing may be defined as

- the objective, systematic, professional and independent examination
- of financial, administrative and other operations of a public entity made subsequently to their execution
- for the purpose of evaluating and verifying them, presenting a report containing explanatory comments on audit findings together with conclusions and recommendations
- for future actions by the responsible officials
  and
- in the case of examination of financial statements, expressing the appropriate professional opinion regarding the fairness of the presentation

3. Objective of Government Audit

The objectives of Govt. Audit are



(a) **Accounting for Public Funds**: -Government audit serves as a mechanism or process for public accounting of government funds.

(b) **Appraisal of Government policies**: -It also provides public accounting of the operational, management, programme and policy aspects of public administration as well as accountability of the officials administering them.

(c) **Base for Corrective actions: -**Audit observations based on factual data collection also serve to highlight the lapses of the lower hierarchy, thus helping supervisory level officers to take corrective measures.

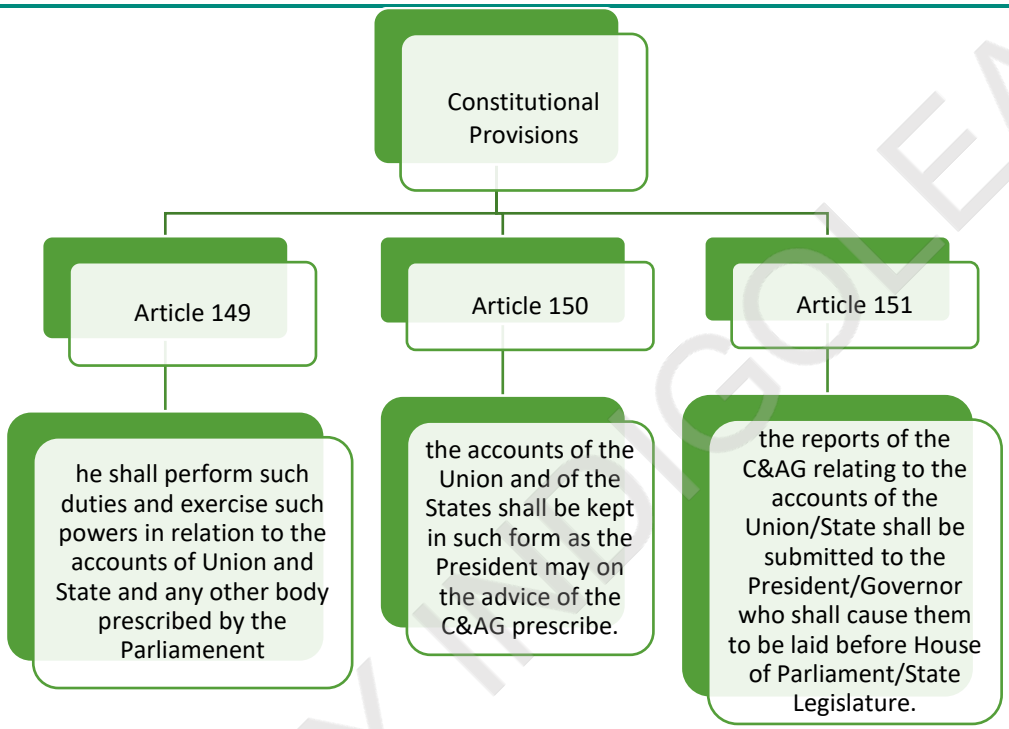
(d) **Administrative accountability**: - Government audit is neither equipped nor intended to function as an investigating agency, to pursue every irregularity or misdemeanour to its logical end. The main objective of audit is a combination of ensuring accountability of administration to legislature and functioning as an aid to administration.

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4. Legal Framework and Comptroller and Auditor General of India

Appointment: CAG shall be appointed by the President of India
Removal: CAG shall not be removed from office except on the ground of proven mis-behaviour or incapacity. He can be removed only when each House of Parliament decides to do so by a majority of not less than 2/3rd of the members of the House present and voting.
Remuneration: The Parliament is competent to make laws to determine salary and other conditions of service and they cannot be varied to his disadvantage after his appointment. CAG should be paid remuneration equivalent to that of SC judge.
Tenure: CAG shall hold office for 6 years or upto the age of 65 years, whichever is earlier

5. Constitutional Provisons



6. Duties of CAG

Duties of the C&AG:

(i) **Compile and submit Accounts of Union and States** - The Comptroller and Auditor General shall be responsible for compiling the accounts of the Union and of each State and submit those accounts to the President or Governor or Administrator.

The CAG shall, give to the Union Government, to the State Government or to the Governments of Union Territories having Legislative Assemblies, as the case may be, such information as they may, from time to time, require and render such assistance in the preparation of the annual financial statements as they may reasonably ask for.

(ii) General Provisions relating to Audit:

It shall be the duty of the Comptroller and Auditor General—

a. to audit and report on all expenditure from the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to ascertain whether the moneys shown in the accounts

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as having been disbursed were legally available for and applicable to the service or purpose to which they have been applied or charged and whether the expenditure conforms to the authority which governs it;

b. to audit and report all transactions of the Union and of the States relating to Contingency Funds and Public Accounts;

c. to audit and report on all trading, manufacturing and profit and loss accounts and balance-sheets and other subsidiary accounts kept in any department of the Union or of a Stat**e.**

(iii) **Audit of Receipts and Expenditure –**

Where anybody or authority is **substantially financed** by grants or loans from the Consolidated Fund of India or of any State or of any Union Territory, the CAG shall, ***audit all receipts and expenditure of that body or authority and to report*** on the receipts and expenditure audited by him.

Meaning of Substantially financed :- Where the grant or loan to a body or authority from the Consolidated Fund of India or of any State or of any Union Territory in a financial year is not less than `

- 25 lakhs and
- the amount of such grant or loan is not less than 75% of the total expenditure of that body or authority,

(iv)**Audit of Grants or Loans** - Where any grant or loan is given for any specific purpose from the Consolidated Fund of India or of any State or of any Union Territory to any authority or body, not being a foreign State or international organisation, the CAG shall scrutinise the procedures by which the sanctioning authority satisfies itself as to the fulfillment of the conditions subject to which such grants or loans were given.

(v) **Audit of Receipts of Union or States** - It shall be the duty of the CAG to audit all receipts which are payable into the Consolidated Fund of India and of each State and of each Union Territory and to satisfy himself that the rules and procedures in that behalf are designed to secure an effective check on the assessment, collection and proper allocation of revenue.

(vi) **Audit of Accounts of Stores and Inventory** - The Comptroller and Auditor General shall have authority to audit and report on the accounts of stores and inventory kept in any office or department of the Union or of a State.

(vii) **Audit of Government Companies and Corporations** - The duties and powers of the Comptroller and Auditor General in relation to the audit of the accounts of government companies shall be performed and exercised by him in accordance with the provisions of the Companies Act, 2013.

(a) The Comptroller and Auditor- General of India shall appoint the auditor under section 139(5) or 139(7) (i.e., appointment of First Auditor or Subsequent Auditor) and

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(b) direct such auditor the manner in which the accounts of the Government company are required to be audited and

(c) thereupon the auditor so appointed shall submit a copy of the audit report to the CAG of India which, among other things, include the directions, if any, issued by the Comptroller and Auditor-General of India, the action taken thereon and its impact on the accounts and financial statement of the company.

7. Powers of CAG



The C&AG Act gives the following powers to the C&AG in connection with the performance of his duties-

(a) ***To inspect*** any office of accounts under the control of the Union or a State Government including office responsible for the creation of the initial or subsidiary accounts.

(b) ***To require*** that any accounts, books, papers and other documents which deal with or are otherwise relevant to the transactions under audit, be sent to specified places.

(c) To ***put such questions*** or make such observations as he may consider necessary to the person in charge of the office and to call for such information as he may require for the preparation of any account or report which is his duty to prepare.

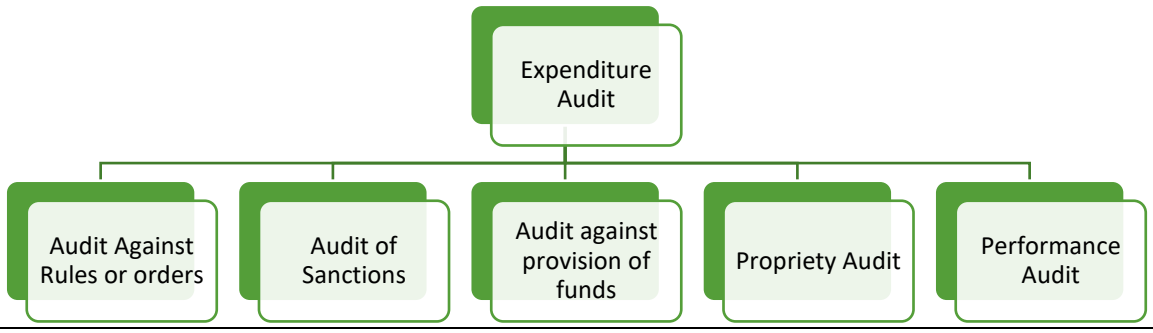
(d) In carrying out the audit, the C&AG has the power to dispense with any part of detailed audit of any accounts or class of transactions and to apply such limited checks in relation to such accounts or transactions as he may determine.

EXPENDITURE AUDIT

The basic standards set for audit of expenditure are to ensure that there is provision of funds authorised by competent authority fixing the limits within which expenditure can be incurred. These standards are—

- That the expenditure incurred conforms to the relevant provisions of the statutory enactment and in accordance with the Financial Rules and Regulations framed by the competent authority. Such an audit is called as the **audit against 'rules and orders'.**
- that there is sanction, either special or general, accorded by competent authority authorising the expenditure. Such an audit is called as the **audit of sanctions**.
- that there is a provision of funds out of which expenditure can be incurred and the same has been authorised by competent authority. Such an audit is called as **audit against provision of funds.**
- that the expenditure is incurred with due regard to broad and general principles of financial propriety. Such an audit is also called as **propriety audit.**
- that the various programmes, schemes and projects where large financial expenditure has been incurred are being run economically and are yielding results expected of them. Such an audit is termed as the **performance audit.**

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Audit against Rules & Orders

It aims to ensure that the expenditure conforms to the relevant provisions of the Constitution and of the laws and rules made thereunder. It also seeks to satisfy that the expenditure is in accordance with the financial rules, regulations and orders issued by a competent authority.

These rules, regulations and orders against which regularity audit is conducted mainly fall under the following categories:

(i) Rules and orders regulating the powers to incur and sanction expenditure from the Consolidated Fund of India or of a State (and the Contingency Fund of India or of a State);

(ii) Rules and orders dealing with the mode of presentation of claims against government, withdrawing moneys from the Consolidated Fund, Contingency Fund and Public Accounts of the Government of the India and of the States, and in general the financial rules prescribing the detailed procedure to be followed by government servants in dealing with government transactions; and

(iii) Rules and orders regulating the conditions of service, pay and allowances, and pensions of government servants.

It is the function of the executive government to frame rules, regulations and orders, which are to be observed by its subordinate authorities

It is the function of audit to carry out examination of the various rules, regulations and orders issued by the executive authorities to see that:

(a)	they are not inconsistent with any provisions of the Constitution or any laws made thereunder;
(b)	they are consistent with the essential requirements of audit and accounts as determined by the C&AG;
(c)	they do not come in conflict with the orders of, or rules made by, any higher authority; and
(d)	in case they have not been separately approved by competent authority, the issuing authority possesses the necessary rule-making power.

Audit of sanctions

The auditor has to ensure that each item of expenditure is covered by a sanction, either general or special, of the competent authority.

The audit of sanctions is directed both in respect of ensuring that

- the expenditure is properly covered by a sanction, and
- also to satisfy that the authority sanctioning it is competent for the purpose by virtue of the powers vested.

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Audit against provision of funds

Audit against provision of funds aims at ascertaining that the expenditure incurred has been

- on the purpose for which the grant and appropriation had been provided and
- that the amount of such expenditure does not exceed the appropriation made.

Propriety audit

- According to 'Propriety audit', the auditors try to bring out cases of improper, avoidable, or ineffective expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations.
- A transaction may satisfy all the requirements of regularity audit insofar as the various formalities regarding rules and regulations are concerned, but may still be highly wasteful. e.g.:- A building may be constructed for installing a telephone exchange but may not be used for the same purpose resulting in unproductive expenditure or a school building may be constructed but used after five years of its completion is a case of avoidable expenditure.
- **Audit against propriety seeks to ensure that expenditure conforms to these principles which have been stated as follows**:
    - The expenditure should not be prima facie more than the occasion demands. Every public officer is expected to exercise the same vigilance in respect of expenditure incurred from public moneys as a person of ordinary prudence would exercise in respect of expenditure of his own money.
    - No authority should exercise its powers of sanctioning expenditure to pass an order which will be directly or indirectly to its own advantage.
    - Public moneys should not be utilised for the benefit of a particular person or section of the community unless:
        - the amount of expenditure involved is insignificant; or
        - a claim for the amount could be enforced in a Court of law; or
        - the expenditure is in pursuance of a recognised policy or custom; and
        - the amount of allowances, such as travelling allowances, granted to meet expenditure of a particular type should be so regulated that the allowances are not, on the whole, sources of profit to the recipients.

It is the responsibility of the executive departments to enforce economy in public expenditure. The function of audit is to bring to the notice of the proper authorities of wastefulness in public administration and cases of improper, avoidable and ineffective/unproductive expenditure

Performance Audit

The scope of audit has been extended to cover efficiency, economy and effectiveness audit or performance audit, or full scope audit: -

Efficiency audit: looks into whether the various schemes/projects are executed and their operations conducted economically and whether they are yielding the results expected of them, i.e., the relationship between goods and services produced and resources used to produce them; and examination aimed to find out the extent to which operations are carried out in an economical and efficient manner.

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Economy audit: looks into whether government have acquired the financial, human and physical resources in an economical manner, and whether the sanctioning and spending authorities have observed economy.

Effectiveness audit: is an appraisal of the performance of programmes, schemes, projects with reference to the overall targeted objectives as well as efficiency of the means adopted for the attainment of the objectives.

Efficiency- cum-performance audit: wherever used, is an objective examination of the financial and operational performance of an organisation, programme, authority or function and is oriented towards identifying opportunities for greater economy, and effectiveness.

The procedure for conducting performance audit covers
• identification of topic,
• preliminary study,
• planning,
• execution of audit, and
• reporting.

Audit of Receipts

An audit of receipts provides for checking;

(i) whether all revenues or other debts due to government have been correctly assessed, realised and credited to government account by the designated authorities;

(ii) whether adequate regulations and procedures have been framed by the department/agency concerned to secure an effective check on assessment, collection and proper allocation of cases;

(iii) whether such regulations and procedures are actually being carried out;

(iv) whether adequate checks are imposed to ensure the prompt detection and investigation of irregularities, double refunds, fraudulent or forged refund vouchers or other loss of revenue through fraud or willful omission or negligence to levy or collect taxes or to issue refunds; and

(v) review of systems and procedures to see that the internal procedures adequately secure correct and regular accounting of demands collection and refunds and pursuant of dues up to final settlement and to suggest improvement.

Note:

• The extent and quantum of audit required to be done under each category of audit are determined by the C&AG.
• Institutional mechanism provides for primary check by the auditor, test check by the supervisor and control and direction by the group leader.
• Planning, executing and reporting of work is directed and monitored at middle and top levels of the audit hierarchy. There are built-in arrangements within the C&AG to ensure that the work assigned to each employee is carried out as prescribed.
• The audit is conducted both centrally where accounts and original vouchers are kept and locally where the drawing and disbursing functions are performed depending on the organisational and institutional arrangements obtaining.

Audit of Stores and Inventories

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Audit is conducted: -

- to ascertain whether the Regulations governing purchase, receipt and issue, custody, sale and inventory taking of stores are well devised and properly carried out.

- to bring to the notice of the government any deficiencies in quantities of stores held or any defects in the system of control.

- to verify that the purchases are properly sanctioned, made economical and in accordance with the Rules for purchase laid down by the competent authority.

- to ensure that the prices paid are reasonable and are in agreement with those shown in the contract for the supply of stores, and that the certificates of quality and quantity are furnished by the inspecting and receiving units. Cases of uneconomical purchase of stores and losses attributable to defective or inferior quality of stores are specifically brought by the audit.

- to check the accounts of receipts, issues and balances regarding accuracy, correctness and reasonableness of balances in inventories with particular reference to the specified norms for level of consumption of inventory holding.

Audit of Commercial Accounts

Public enterprises are required to maintain commercial accounts and are generally classified under three categories—

(a) **departmental enterprises** engaged in commercial and trading operations, which are subject to the same laws, financial and other regulations as other government departments and agencies;

(b) **statutory bodies, corporations**, created by specific statutes mostly financed by government in the form of loans, grants, etc.; and

(c) **government companies** set up under the Companies Act, 2013.

The audit of :-

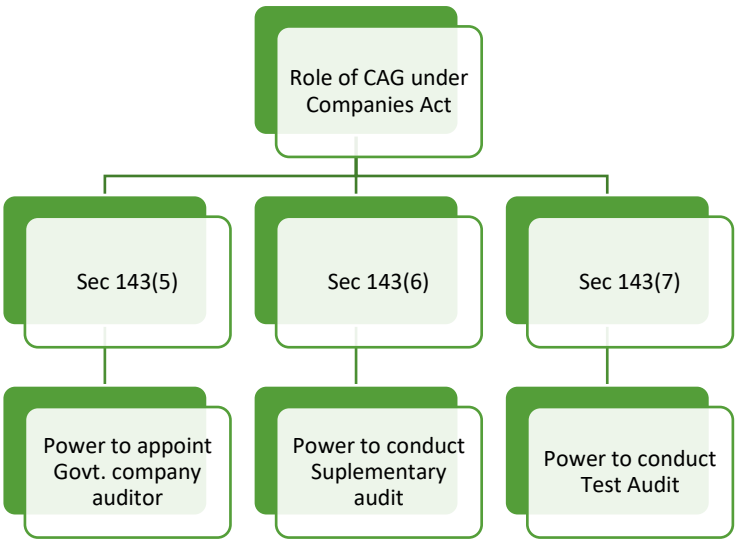
- **Departmental concerns** is undertaken in the same manner as any department of government where commercial accounts are kept.

- **Statutory bodies or corporations** depends on the nature and type of the statute governing the bodies or corporations..

- **Government companies** is conducted by their own auditors under the statute appointed by C&AG. In addition, the C&AG conducts a supplementary test audit of the accounts, as well as periodical financial audit and appraisal of performance. The C&AG also issues direction to the company auditors for reporting on specific aspects of their audit work. These are reviewed, and condensed in the audit reports to the government/legislatures. C&AG has adopted the mechanism of an Audit Board-comprising of representatives of the audit and nominees of government including functional specialists to process reviews or appraisals on performance.

Role of C&AG under the Companies Act, 2013.

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Sec 143(5): The CAG of India shall appoint the First Auditor or Subsequent Auditor and direct such auditor the manner in which the accounts of the Government company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor-General of India.

Sec 143(6): The CAG of India shall within 60 days from the date of receipt of the audit report have a right to,

(a) **conduct a supplementary audit** under section 143(6)(a), of the financial statement of the company by such person or persons as he may authorize in this behalf; and for the purposes of such audit, require information or additional information to be furnished to any person or persons, so authorised, on such matters, by such person or persons, and in such form, as the CAG may direct; and

(b)**comment upon or supplement** such audit report.

Any comments given by the Comptroller and Auditor-General of India upon, or supplement to, the audit report shall be sent by the company to every person entitled to copies of audited financial statements.

Sec 143 (7): the CAG of India may, if he considers necessary, by an order, cause test audit to be conducted of the accounts of such company and the provisions of section 19A of the Comptroller and Auditor- General's (Duties, Powers and Conditions of Service) Act, 1971, shall apply to the report of such test audit.

The statutory auditors shall submit a copy of their audit report to the C&AG who shall have a right to comment upon or supplement the audit report submitted by the statutory auditors in such manner as he may think fit. Section 134(3) of the Companies Act, 2013 imposes a duty on the board of directors of a company to give an explanation or comments on every reservation, or adverse remarks or disclaimer contained in the auditors' report and secretarial audit report of the Company Secretary in practice. In the absence of similar provisions requiring the company to give reply on the reservation made by the C&AG, the board of directors of such a company is not bound to give information or explanation in respect of such comments.

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Reporting Procedures

- The effectiveness of an audit depends on reporting results to the proper authority so that appropriate action may be taken to rectify the irregularities or impropriety where possible or to prevent re-occurrence.
- Article 151 of the Indian Constitution enjoins that the C&AG shall report on the accounts of the Union and of each of the States to the President or the Governor concern and the latter shall cause the report to be laid before the legislatures
- The reports should not only be presented to the legislatures but thereafter also publicised adequately in order to create a proper climate of public opinion for taking remedial action where necessary, on the findings of the Auditor General.
- In India, the reporting is factual and the conclusions are left to be drawn by the reader. This is presumably to ensure total objectivity.

Audit of Local Bodies

Background

Municipality can be defined as a unit of local self-government in an urban area. By the term 'local self-government' is ordinarily understood the administration of a locality – a village, a town, a city or any other area smaller than a state – by a body representing the local inhabitants, possessing fairly large autonomy, raising at least a part of its revenue through local taxation and spending its income on services which are regarded as local and, therefore, distinct from state and central services.

Types: Municipal Government in India covers five different types of urban local authorities:

- Municipal Corporations
- Municipal Councils
- Notified Area Committees
- Town Area Committees
- Cantonments Committees

Functions: The functions of Municipal Authorities are endowed with specific local functions covering:

- Regulatory
- Maintenance and
- Development activities.

Sources of funds: The auditor verifies the following income with the available evidence:

- Properly taxes & Octroi
- Profession tax
- Non - mechanized vehicles tax
- Taxes on advertisements
- Taxes on animals & boats
- Tolls
- Show tax

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- Different types of grants from the state
- Administration.

Application of fund: The Auditor vouches following expenditures for the accuracy & propriety:

- General administration & revenue collection
- Public health
- Public safety
- Education, Public works etc.

Types of Grants

Local bodies may receive different types of grants from the state administration as well. Broadly, the revenue grants are of three categories:

(a) **General purpose grants**: These are primarily intended to substantially bridge the gap between the needs and resources of the local bodies.

(b) **Specific purpose grants**: These grants which are tied to the provision of certain services or performance of certain tasks.

(c) **Statutory and compensatory grants**: These grants, under various enactments, are given to local bodies as compensation on account of loss of any revenue on taking over a tax by state government from local government.

Salient features of Financial Administration of Local Bodies

The salient features of Financial Administration of Local Bodies may be grouped under three heads:



Budgetary Control:

- This is geared to subserve the twin considerations of financial accountability and control of expenditure.
- The main objective is to ensure that funds are raised and moneys are spent by the executive departments in accordance with the rules and regulations and within the limits of sanction and authorisation by the legislature or council.
- Budget preparation is usually the occasion for determining the levels of taxation and rates and the ceilings on expenditure.
- There is no strict separation between revenue and capital items;

(b) Expenditure Control:

- The system of financial control existing in the state and central government level is conditioned by the fact that there is a clear demarcation between the legislature and executive.
- The integration of legislation and executive powers in the municipal council makes it difficult for its executive to function as its inquisitorial body as well.
- Moreover the separation of executive powers and functions in municipal government cannot accommodate the existence of an independent finance officer responsible to the municipal council or its executive committee. This leaves the system of external audit by state government as the only instrument of controlling municipal expenditure.

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(c) Accounting System:

- Municipal accounting and budget format have been criticised as neither simple nor comprehensible, sometimes providing inadequate information and at other times a surfeit of information.
- Both these situations are not conducive to a proper system of management information.

Objectives of Audit

- Reporting on the fairness of the content and presentation of financial statements
- Reporting upon the strengths and weaknesses of systems of financial controls
- Reporting on the adherence to legal and / or administrative requirements
- Reporting upon whether value is being fully received on money spent, and
- Detection and Prevention of error, fraud, and misuse of resources.

Audit Program

(i) **APPOINTMENT: -**

- The Local Fund Audit Wing of the State Govt. is generally in-charge of the audit of municipal accounts.
- Sometimes bigger municipal corporations e.g. Delhi, Mumbai etc. have power to appoint their own auditors for regular external audit.
- The auditor should ensure his appointment.

(ii) **AUDITOR'S CONCERNS**: -The auditor while auditing the local bodies should report on the

•	fairness of the contents and presentation of financial statements,
•	the strengths and weaknesses of system of financial control,
•	the adherence to legal and/or administrative requirements;
•	whether value is being fully received on money spent.

His objective should be to detect errors and fraud and misuse of resources

(iii) **RULES & REGULATIONS**: - The auditor should ensure that the expenditure incurred conforms to the relevant provisions of the law and is in accordance with the financial rules and regulations framed by the competent authority.

(iv) **AUTHORISATIONS: -** He should ensure that all types of sanctions, either special or general, accorded by the competent authority.

(v) **PROVISIONING: -** He should ensure that there is a provision of funds and the expenditure is incurred from the provision and the same has been authorized by the competent authority.

(vi) **PERFORMANCE: -** The auditor should check that the different schemes, programmes and projects, where large financial expenditure has been incurred, are running economically and getting the expected results.

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Background

- NGOs can be defined as non-profit making organisations which raise funds from members, donors or contributors apart from receiving donation of time, energy and skills for achieving their social objectives like imparting education, providing medical facilities etc
- This definition of NGO would include religious organisations, voluntary health and welfare agencies, charitable organisations, hospitals, old age homes, research foundations etc.
- Non-Governmental Organisations are generally incorporated as
    - societies under the Societies Registration Act, 1860 or
    - as a trust under the India Trust Act, 1882, or
    - under any other law corresponding to these Laws enforced in any part of India.
    - NGOs can also be incorporated as a company under section 8 of the Companies Act, 2013

None of the above-mentioned Act warrant a mandatory registration under them for an NGO. But if an NGO is created as a trust and trust relates to immovable property worth more than one hundred rupees, the provision of Section 17(1) of the Registration Act, 1908 read with Section 123 of the Transfer of Property Act, 1882 must be complied with and the registration of trust becomes mandatory. In some states, such as the states of Maharashtra and Gujarat, where Public Trusts Acts have been passed, such as the Bombay Public Trusts Act 1950, all charitable trusts have to be registered under these specific Public Trusts Acts. Registration under the Income Tax Act, 1961 and the Foreign Contribution (Regulation) Act, 2010 would also be invoked in many cases.

Sources and Applications of Funds

SOURCES OF FUNDS

- **Revolving fund contribution**: The aim of this fund is to revolve the amount by giving temporary loans. The interest income earned there from is added to the fund.
- **Corpus contribution**: A contribution made towards the capital corpus of an NGO is known as corpus contribution.
- **Specific donations**: These are acquired for specific purposes like acquiring fixed assets.
- **Contributions in kind** includes assets such as land, building, vehicles etc.
- **Other income**: Advertisement fees from members:
    - Subscriptions
    - Income from fund raising concerts.

Note:

a) Donations and grants received in the nature of promoter's contribution are in the nature of capital receipts and shown as liabilities in the Balance Sheet of NGO.
b) A contribution made towards the capital or the corpus of an NGO is known as corpus contribution

APPLICATION OF FUNDS

- Establishment costs.
- Maintenance expenses.
- Office and administration expenses.

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- Program / Project expenses.
- Charity.
- Donation and contributions given.

Provisions Relating to Audit

- The auditors of an NGO registered under the Societies Registration Act, 1860 or the Indian Trusts Act 1882 are normally appointed by the Management of the Society or Trust.
- The auditors of NGO registered under section 8 of the Companies Act, 2013 are appointed by the members of the company.
- The Companies Act, 2013, Foreign Contribution (Regulation) Act 2010, Income Tax Act 1961 required that the accounts of the NGO be audited and submitted to the prescribed authorities and failure to do so could lead to forfeiture of certain exemptions and benefits.
- The Foreign Contribution (Regulation) Act 2010 has prescribed the format and requires that the same be furnished to the Ministry of Home Affairs within 60 days from the close of the financial year i.e. by May 30 each year.

While planning the audit, the auditor may concentrate on the following:

(i) Knowledge of the NGO's work, its mission and vision, areas of operations and environment in which it operate.
(ii) Updating knowledge of relevant statutes especially with regard to recent amendments, circulars, judicial decisions viz. Foreign Contribution (Regulation) Act 2010, Societies Registration Act, 1860, Income Tax Act 1961 etc. and the Rules related to the statutes.
(iii) Reviewing the legal form of the Organisation and its Memorandum of Association, Articles of Association, Rules and Regulations.
(iv) Reviewing the NGO's Organisation chart, then Financial and Administrative Manuals, Project and Programme Guidelines, Funding Agencies Requirements and formats, budgetary policies if any.
(v) Examination of minutes of the Board/Managing Committee/Governing Body/ Management and Committees thereof to ascertain the impact of any decisions on the financial records.
(vi) Study the accounting system, procedures, internal controls and internal checks existing for the NGO and verify their applicability.
(vii) Setting of materiality levels for audit purposes.
(viii) The nature and timing of reports or other communications.
(ix) The involvement of experts and their reports.
(x) Review the previous year's Audit Report.

MATERIAL ITEMS TO BE VERIFIED

(i) **Corpus Fund**: The contributions / grants received towards corpus be vouched with special reference to the letters from the donor(s). The interest income be checked with Investment Register and Physical Investments in hand.

(ii) **Reserves**: Vouch transfers from projects / programmes with donors' letters and board resolutions of NGO. Also check transfer of gross value of asset sold from capital reserve to general reserve and adjustments during the year.

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(iii) **Ear-marked Funds**: Check requirements of donor's institutions, board resolution of NGO, rules and regulations of the schemes of the ear- marked funds.

(iv) **Project / Agency Balances**: Vouch disbursements and expenditure as per agreements with donors for each of the balances.

(v) **Loans:** Vouch loans with loan agreements, counterfoil of receipt issued.

(vi) **Fixed Assets**: Vouch all acquisitions / sale or disposal of assets including depreciation and the authorisations for the same. Also check donor's letters/ agreements for the grant. In the case of immovable property check title, etc.

(vii) **Investments**: Check Investment Register and the investments physically ensuring that investments are in the name of the NGO. Verify further investments and dis- investments for approval by the appropriate authority and reference in the bank accounts for the principal amount and interest.

(viii) **Cash in Hand:** Physically verify the cash in hand and imprest balances, at the close of the year and whether it tallies with the books of account.

(ix) **Bank Balance**: Check the bank reconciliation statements and ascertain details for old outstanding and unadjusted amounts.

(x) **Inventory**: Verify inventory in hand and obtain certificate from the management for the quantities and valuation of the same.

(xi) **Programme and Project Expenses**: Verify agreement with donor/contributor(s) supporting the particular programme or project to ascertain the conditions with respect to undertaking the programme/project and accordingly, in the case of programmes/projects involving contracts, ensure that income tax is deducted, deposited and returns filed and verify the terms of the contract.

(xii) **Establishment Expenses:** Verify that provident fund, life insurance premium, employees state insurance and their administrative charges are deducted, contributed and deposited within the prescribed time.

Also check other office and administrative expenses such as postage, stationery, travelling, etc.

The receipt of income of NGO may be checked on the following lines:

(i) **Contributions and Grants for projects and programmes**: Check agreements with donors and grants letters to ensure that funds received have been accounted for. Check that all foreign contribution receipts are deposited in the foreign contribution bank account as notified under the Foreign Contribution (Regulation) Act, 2010

(ii) **Receipts from fund raising programmes**: Verify in detail the internal control system and ascertain who are the persons responsible for collection of funds and mode of receipt. Ensure that collections are counted and deposited in the bank daily.

(iii) **Membership Fees:** Check fees received with Membership Register. Ensure proper classification is made between entrance and annual fees and life membership fees. Reconcile fees received with fees to be received during the year.

(iv) **Subscriptions**: Check with subscription register and receipts issued. Reconcile subscription received with printing and dispatch of corresponding magazine / circulars / periodicals. Check the receipts with subscription rate schedule.

(v) **Interest and Dividends:** Check the interest and dividends received and receivable with investments held during the year.

AUDIT OF SOLE TRADER

- A sole trader is under no legal obligation to have his accounts audited.
- Many such individuals get their financial statement audited due to regulatory requirements, such as inventory brokers or on a specific instructions of the bank for approval of loans, etc.

APPOINTMENT OF AUDITOR

- Auditors of sole- proprietary concern shall be appointed by the sole proprietor himself.
- It is desirable that the contract of appointment of auditor in such a case should be in writing;
- also that it should clearly define the scope of the work which the auditor is expected to carry out. This helps to prevent misunderstanding.
- If the appointment of the auditor is not in writing, the auditor should write to his client explaining the scope of his duties. While doing so, he should state the limitations, if any, placed upon his work to obtain the client's confirmation.
- The advantages and audit procedure discussed in following paragraphs of audit in case of partnership firm would be similar in case of proprietorship. (REFER AUDIT OF PARTNERSHIP FIRM)

AUDIT OF PARTNERSHIP FIRM

Appointment of Auditors:

- The auditor to a firm is usually appointed by the partners either on the basis of a decision taken by them or to comply with a condition in the partnership agreement.
- His remuneration is also fixed by the partners.
- It is important that the letter of appointment should clearly state the nature and scope of audit which is to be carried out and particulars of limitations, if any, under which he would have to function.
- In case of change of auditor, it would be duty of incoming auditor to communicate with the previous auditor.
- In case the firm is required to get its accounts audited under the requirements of any statute, the auditor will have to qualify the report in case of non-compliance with the accounting standards.

Matters to be considered before starting audit: Also, before starting the audit, he should examine the partnership agreement and note the provisions therein as regards the following matters:

1.	The name and style under which the business shall be conducted.
2.	The duration of the partnership, if any, that has been agreed upon.
3.	The amount of capital that shall be contributed by each partner—whether it will be fixed or could be varied from year to year.
4.	The period at the end of which the accounts of the partnership will be closed periodically and the proportions in which the profit shall be divided among the partners or losses shall have to be contributed by them; whether the losses shall be borne by the partners or whether any of the partners will not be required to do so.
5.	The provisions as regards maintenance of books of accounts.
6.	Borrowing capacity of the partnership.

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7.	The rate at which interest will be allowed on the capitals and loans provided by partners and the rate at which it will be charged on their drawings and current accounts.
8.	Whether any salaries are payable to the partners or withdrawals are permitted against shares of profits and, if so, to what extent?
9.	Duties of the partners as regards the management of business of the firm;
10.	Who shall operate the bank account of the firm? How will the surplus funds of the partnership be invested?
11.	Limitations and restrictions that have been agreed upon, the rights and powers of partners and on their implied authority to pledge the firm's credit or to render it liable.

Advantages of Audit of a Partnership Firm –

The advantages of audit of accounts of a partnership could be stated as follows:

(1) **Disputes**:- Audited accounts provide a convenient and reliable means of settling accounts between the partners and, thereby, the possibility of occurrence of a dispute among them is mitigated.

(2) **Dissolution:-** On the retirement or death of a partner, audited accounts, which have been accepted by the partners, constitute a reliable evidence for computing the amounts due to the retiring partner or to the representative of the deceased partner in respect of his share of capital, profits and goodwill.

(3) **Reliable:**- Audited statement of accounts are relied upon by the banks when advancing loans, as well as by prospective purchasers of the business, as evidence of the profitability of the concern and its financial position.

(4) **Admission**:- Audited statements of account can be helpful in the negotiations to admit a person as a partner, especially when they are available for a number of past years.

(5) **Control: -** An audit is an effective safeguard against any undue advantage being taken by a working partner or partners especially in the case of those partners who are not actively associated with the working of the firm.

Matters which should be specially considered in the audit of accounts of a partnership:

(i) **Letter of Appointment**: - Confirming that the letter of appointment, signed by a partner, duly authorised, clearly states the nature and scope of audit contemplated by the partners, especially the limitation, if any, under which the auditor shall have to function.

(ii) **Partnership Documents**: - Studying the minute book, if any, maintained to record the policy decision taken by partners specially the minutes relating to authorisation of extraordinary and capital expenditure, raising of loans; purchase of assets, extraordinary contracts entered into and other such matters as are not of a routine nature.

(iii) **Objects of Partnership**: - Verifying that the business in which the partnership is engaged is authorised by the partnership agreement; or by any extension or modification thereof agreed to subsequently.

(iv) **Books of Account: -** Examining whether books of account appear to be reasonable and are considered adequate in relation to the nature of the business of the partnership.

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(v) **Mutual Interest**: - Verifying generally that the interest of no partner has suffered prejudicially by an activity engaged in by the partnership which, it was not authorised to do under the partnership deed or by any violation of a provision in the partnership agreements.

(vi) **Provision for Taxes**: - Confirming that a provision for the firm's tax payable by the partnership has been made in the accounts before arriving at the amount of profit divisible among the partners.

(viii) **Division of Profits**: - Verifying that the profits and losses have been divided among the partners in their agreed profit-sharing ratio.

Audit of LLP

Introduction

- LLP is governed by Limited Liability Partnership Act, 2008.
- Minimum of 2 Partners can form an LLP and atleast 2 partners would be Designated Partners who would be required to take DPIN (Designated Partner Identification Number).

Small Limited Liability Partnership: Any LLP:

a) Contribution of which, does not exceed ₹ 25.00.000 or such higher amount, not exceeding ₹ 5 crore, as may be prescribed; and

b) Turnover of which, as per the Statement of Accounts and Solvency for the immediately preceding financial year, does not exceed ₹ 40.00,000 or such higher amount, not exceeding ₹ 50 crore, as may be prescribed.

Books of Accounts

LLP shall maintain such proper books of account which shall contain:

a) particulars of all sums of money received and expended by the LLP and the matters in respect of which the receipt and expenditure takes place;

b) a record of the assets and liabilities of the LLP;

c) Statements of cost of goods purchased, inventories, WIP, finished goods and cost of goods sold; and

d) any other particulars which the partners may decide.

Audit of Accounts

- Accounts of LLP shall be audited in accordance with Rule 24 of LLP Rules, 2009.
- LLP whose turnover does not exceed, in any financial year, ₹ 40 Lakh, or whose contribution does not exceed ₹ 25 Lakh shall not be required to get its accounts audited.

If partners of such LLP decide to get the accounts of such LLP audited, the accounts shall be audited in accordance with these rules.

Advantages/ Purpose/Need of Audit

- **Detection of Errors**: Auditing accounts helps in detecting errors & frauds & verification of financial statements.
- **Disputes:** Disputes, if any between any partners in the matter of accounts can be settled with the help of audited accounts.

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- **Reliability**: Banks & financial institutions lend money to the firms only on the basis of audited accounts.

- **Better Compliance and Management**: Periodical visits & suggestions by the auditor will be helpful in improving the management of the LLP.

- **Reconstitution:** For settling accounts between partners at the time of admission, death, retirement, insolvency, insanity, etc. audited accounts are accepted by those concerned who have dealings with the LLP.

Returns to be maintained and filed by an LLP

- Every LLP Would be required to file annual return in Form 11 with ROC within 60 days of closer of financial year. The annual return will be available for public inspection on payment of prescribed fees to Registrar.

- Every LLP is also required to submit Statement of Account and Solvency in Form 8 which shall be filed within a period of 30 days from the end of 6 months the financial year to which the Statement of Account and Solvency relates.

Appointment of Auditor

- **Auditor may be appointed by the designated partners of the LLP:**

a) At any time for the first financial year but before the end of first financial year.

b) At least 30 days prior to the end of each financial year (other than the first financial year).

c) To fill the casual vacancy in the office of auditor.

d) To fill the casual vacancy caused by removal of auditor.

Note: **Partners may appoint the auditors if the designated partners have failed to appoint them**.

Auditor's duty regarding Audit of LLP

a) **Engagement letter**: Auditor should obtain instructions in writing as to the work to be performed by him.

b) **Minute Book**: If minute book is being maintained, auditor shall refer it for any resolution passed regarding the accounts.

c) **LLP Agreement**: Auditor should read the LLP agreement & note the following provisions

- Nature of the business of LLP
- Capital contributed by each partner
- Interest in respect of capital contributions
- Duration of partnership
- Drawings allowed to the partners
- Salaries, commission etc. payable to partners
- Rights & duties of partners
- Method of settlement of accounts between partners at the time of admission, retirement, admission etc.
- Any loans advanced by the partners

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- Profit sharing ratio

d) **Reporting**: Auditor should report

- Whether the records reflect true and fair view;
- Whether he obtains all information & explanation;
- Whether any restriction imposed upon him.

Audit of Charitable Institutions

In the case of audit of a charitable institution, attention should be paid to the following matters-

General

I. Determine the constitution under which the charitable institution has been established.

II. Ensure that the institution is being managed in the manner contemplated by the law under which it has been established.

III. Examine the system of internal check, especially as to accounting of receipts.

IV. Verifying in detail the income and ensure that the amounts received have been deposited in the bank regularly and promptly.

Incomes

Subscriptions and donations

I. Determine whether any changes made in amount of annual or life membership subscription during the year.

II. Ensure the following in relation to official receipts;

a. issue of official receipts

b. adequate control is imposed over unused receipt books;

c. obtain all receipt books covering the period under review;

d. test check the counterfoils with the cash book;

e. cancelled receipts to be specially looked into;

f. obtain the printed list of subscriptions and donations and agreeing them with the total collections shown in the accounts;

g. examine the system of internal check regarding moneys received from box collections, flag days, etc., and

h. Verifying the total subscriptions and donations received with any figures published in reports, etc. issued by the charity.

Other incomes

a) **Legacies and Grants:** Verify amounts of legacies, grants, charities etc. received by reference to correspondence with any figures and other available information.

b) **Investment Income:**

- Vouch amounts received with dividend and interest counterfoils.

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- Check calculations of interest received on securities bearing fixed rates of interest.
- Check that appropriate dividend has been received where any investment has been sold ex-dividend or purchased cum-dividend.
- Compare dividend received with schedule of investments making special enquiries into any investments held for which no dividend has been received.

c) **Rental Income**: If any property is given or taken on rent, the tenancy agreement should be checked to determine the accuracy of rent received or paid.

d) **Special functions**: Vouching gross receipts and outgoings in respect of any special functions, e.g., concerts, dramatic performance, etc., held in aid of the charity with such vouchers and cash statements as are necessary. In particular, verifying that the proceeds of all tickets issued have been accounted for, after making the allowance for returns.

(e) **Income-tax Refunds:**

Where income-tax has been deducted at source from Investment income, it should be seen that a refund thereof has been obtained since charitable institutions are exempt from payment of Income-tax. This involves:

- Vouching the refund with correspondence with the Income-tax department; and
- Checking the calculation of the repayment of claims.

Expenditures

I. If any grant is being allowed to any person, verify whether grant have been paid only for a charitable purpose or purposes falling within the purview of the objects.

II. Verify the schedules of securities held, as well as inventories of properties both movable and immovable by inspecting the securities and title deeds of property and by physical verification of the movable properties on a test basis.

III. Verifying the cash and bank balances.

IV. Ascertaining that any funds contributed for a special purpose have been utilized for the purpose.

Audit of Educational Institutions (school, colleges etc)

General

1. In the case of school or college, examine the Trust Deed or Regulations, and note all the provisions affecting accounts.

2. In the case of a university, refer to the Act of Legislature and the Regulation framed thereunder.

3. Read through the minutes of the meetings of the Managing Committee or Governing Body, noting resolutions affecting accounts to see that these have been duly complied with, specially the decisions as regards the operation of bank accounts and sanctioning of expenditure.

Fee from Students

1. Check names entered in the Students Fee Register and verify that there operates a system of internal check which ensures that demands against the students are properly raised.

2. Check fees received through comparison of counterfoils of receipts issued with entries in the Cash Book.

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3. Examine that fee paid in advance, if any, have been carried forward and that the arrears that are irrecoverable have been written off under the sanction of an appropriate authority.

4. Ensure that admission fees received during the period has been credited to a Capital fund, unless the Managing Committee has taken a decision to the contrary.

5. Check whether scholarships and concessions are granted by authorized person, having regard to the Rules prepared by the managing committee.

6. Confirm that fines for late payment or absence, etc. have been either collected or remitted under proper authority.

7. Confirm that hostel dues were recovered before student's accounts were closed and their deposits of caution money refunded.

Other Receipts/ Grants & Donations

1. Verify rental income from landed property with the rent rolls, etc.

2. Vouch income from endowments and legacies, as well as interest and dividends from investment; also inspect the securities in respect of investments held.

3. Verify any Government or local authority grant with the memo of grant. If any expense has been disallowed for purposes of grant. Ascertain the reasons thereof.

Expenditure

1. Verify that the Provident Fund money of the staff has been invested in appropriate securities.

2. Vouch donations, if any with the list published with the annual report. If some donations were meant for any specific purpose, see that the money was utilized for the purpose.

3. Vouch, all capital expenditure in the usual way and verify the same with the sanction for the Committee as contained in the minute book.

4. Vouch, in the usual manner, all establishment expenses and enquire into any unduly heavy expenditure under any head. If there was any annual budget prepared, see that any excess under any head over the budgeted amount was duly sanctioned by the Managing Committee. If not, bring it to the Committee's notice in your report.

5. See that increase in the salaries of the staff have been sanctioned and minute by the Committee.

Assets & Liabilities

1. Report any old heavy arrears on account of fees, dormitory rents, etc. to the Managing Committee.

2. Confirm that caution money and other deposits paid by students on admission, have been shown as liability in the balance sheet not transferred to revenue, unless they are not refundable.

3. See that the investments representing endowment funds for prizes are kept separate and any income in excess of the prizes has been accumulated and invested along with the corpus.

4. Ascertain that the system ordering inspection on receipt and issue of provisions, foodstuffs, clothing and other equipment is efficient and all bills are duly authorized and passed before payment.

5. Verify the inventories of furniture, stationery, clothing, provision and all equipment etc. These should be checked by reference to Inventory Register or corresponding inventories of the previous year and values applied to various items should be test checked.

Compliances

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1. Confirm that the refund of taxes deducted from the income from investment (interest on securities etc.) has been claimed and recovered since the institutions are generally exempted from the payment of income-tax.

2. Verify annual statements of account and, while doing so examine that separate statements of account have been prepared as regards Economically-weak Students Fund, Games Fund, Hostel and Provident Fund of staff, etc.

Audit of Hospitals

The special steps involved in such an audit are stated below

1. **Register of patients**: Vouch the Register of patients with copies of bills issued to them. Verify bills for a selected period with the patients' attendance record to see that the bills have been correctly prepared. Also see that bills have been issued to all patients from whom an amount was recoverable according to the rules of the hospital.

2. **Collection of Cash**: Check cash collections as entered in the Cash Book with the receipts, counterfoils and other evidence. For e.g., copies of patient's bill, counterfoils of dividend and other interest warrants, copies of rent bills etc.

3. **Income from Investments**, rent etc.: See by reference to the property and Investment Register that all income that should have been received by way of rent on properties, dividends and interest on securities have been collected.

4. **Legacies and Donations**: Ascertain that legacies and donations received for a specific purpose have been applied in the manner agreed upon.

5. **Reconciliation of Subscriptions**: Trace all collections of subscription and donations from the Cash Book to the respective Registers. Reconcile the total subscriptions due (as shown by the Subscription Register and the amount collected and that still outstanding).

6. **Authorization and sanctions:** Vouch all purchases and expenses and verify that the capital expenditure incurred only with the prior sanction of the trustees of the Managing Committee and that appointments and increments to staff have been duly authorized.

7. **Grants and TDS**: Verify that grants, if any, received from Government or local authority has been duly accounted for. Also, that refund in respect of taxes deducted at source has been claimed.

8. **Budgets:** Compare the totals of various items of expenditure and income with the amount budgeted for them and report to the Trustees or the Managing Committee, significant variations which have taken place.

9. **Internal Check**: Examine the internal check as regards the receipt and issue of stores, medicines, linen, apparatus, clothing, instruments, etc. so as to ensure that purchases have been properly recorded in the inventory Register and that issues have been made only against proper authorization.

10. **Depreciation:** See that depreciation has been written off against all the assets at the appropriate rates.

11. **Registers**: Inspect the bonds, share scrips, title deeds of properties and compare their particulars with those entered in the property and Investment Registers.

12. **Inventories:** Obtain inventories, especially of stocks and stores as at the end of the year and check the percentage of the items physically, also compare their total values with respective ledger balances.

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13. **Management Representation and Certificate**: Get proper Management Representation and Certificate with respect to various aspects covered during the course of audit.

Audit of Club

The special steps involved in such an audit are stated below-

(1) **Entrance Fee** :- Vouch the receipt on account of entrance fees with members' applications, counterfoils issued to them, as well as on a reference to minutes of the Managing Committee.

(2) **Subscriptions** :- Vouch members' subscriptions with the counterfoils of receipt issued to them, trace receipts for a selected period to the Register of Members; also reconcile the amount of total subscriptions due with the amount collected and that outstanding.

(3) **Arrears of Subscriptions** :- Ensure that arrears of subscriptions for the previous year have been correctly brought over and arrears for the year under audit and subscriptions received in advance have been correctly adjusted.

(4) **Arithmetical accuracy** :- Check totals of various columns of the Register of members and tally them across.

(5) **Irrecoverable Member Dues** :- See the Register of Members to ascertain the Member's dues which are in arrear and enquire whether necessary steps have been taken for their recovery; the amount considered irrecoverable should be mentioned in the Audit Report.

(6) **Pricing :**- Verify the internal check as regards members being charged with the price of foodstuffs and drinks provided to them and their guests, as well as, with the fees chargeable for the special services rendered, such as billiards, tennis, etc.

(7) **Member Accounts** :- Trace debits for a selected period from subsidiary registers maintained in respect of supplies and services to members to confirm that the account of every member has been debited with amounts recoverable from him.

(8) **Purchases :**- Vouch purchase of sports items, furniture, crockery, etc. and trace their entries into the respective inventory registers.

(9) **Margins earned** :- Vouch purchases of foodstuffs, cigars, wines, etc., and test their sale price so as to confirm that the normal rates of gross profit have been earned on their sales. The inventory of unsold provisions and stores, at the end of year, should be verified physically and its valuation checked.

(10) **Inventories** :- Check the inventory of furniture, sports material and other assets physically with the respective inventory registers or inventories prepared at the end of theyear.

(11) **Investments** :- Inspect the share scrips and bonds in respect of investments, check their current values for disclosure in final accounts; also ascertain that the arrangements for their safe custody are satisfactory.

(12) **Management Powers** :- Examine the financial powers of the secretary and, if these have been exceeded, report specific case for confirmation by the Managing Committee.

AUDIT OF CINEMA

The special steps involved in its audit are stated below-

(1) Verify the internal control mechanism-

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(a) that entrance to the cinema-hall during show is only through printed tickets;

(b) that they are serially numbered and bound into books;

(c) that the number of tickets issued for each show and class, are different though the numbers of the same class for the show on the same day, each week, run serially;

(d) that for advance booking a separate series of tickets is issued; and

(e) that the inventory of tickets is kept in the custody of a responsible official.

(2) Confirm that at the end of show, a statement of tickets sold is prepared and cash collected is agreed with it.

(3) Verify that a record is kept of the 'free passes' and that these are issued under proper authority.

(4) Reconcile the amount of Tax collected with the total number of tickets issued for each class and vouch and verify the tax returns filed each month.

(5) Vouch the entries in the Cash Book in respect of cash collected on sale of tickets for different shows on a reference to Daily Statements which have been test checked as aforementioned with record of tickets issued for the different shows held.

(6) Verify the charges collected for advertisement slides and shorts by reference to the Register of Slides and Shorts Exhibited kept at the cinema as well with the agreements, entered into with advertisers in this regard.

(7) Vouch the expenditure incurred on advertisement, repairs and maintenance. No part of such expenditure should be capitalized.

(8) Confirm that depreciation on machinery and furniture has been charged at an appropriate rate.

(9) Vouch payments on account of film hire with bills of distributors and in the process, the agreements concerned should be referred to.

(10) Examine unadjusted balance out of advance paid to the distributors against film hire contracts to see that they are good and recoverable. If any film in respect of which an advance was paid has already run, it should be enquired as to why the advance has not been adjusted. The management should be asked to make a provision in respect of advances that are considered irrecoverable.

(11) The arrangement for collection of the share in the restaurant income should be enquired into either a fixed sum or a fixed percentage of the taking may be receivable annually. In case the restaurant is run by the Cinema, its accounts should be checked. The audit should cover sale of various items of foodstuffs, purchase of foodstuffs, cold drink, etc. as in the case of club.

Audit of Hire Purchase and Leasing Companies

Meaning:

A Hire-purchase agreement means an agreement under which goods are let on hire and under which the hirer has an option to purchase them in accordance with the terms of the agreement and includes an agreement under which-

(i) possession of goods is delivered by the owner thereof to a person on condition that such person pays the agreed amount in periodical instalments,

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(ii) the property in the goods is to pass to such person on the payment of the last of such instalments, and

(iii) such person has a right to terminate the agreement at any time before the property so passes.

Hire Purchase Companies

1. The hire purchase agreement should be in writing and be signed by all parties.

2. Hire purchase agreement should clearly specify the following:

- the hire purchase price of the goods;
- the cash price of the goods;
- the date of commencement of the hire purchase agreement;
- the number of instalments by which the hire purchase price is to be paid, the amount of those instalments, the due date etc.;
- the description of goods involved in the hire purchase agreement;
- Procedures to be followed in case of default by the hire purchaser.

3. Check whether the payments are being received regularly as per the agreement.

Leasing Companies

1. Object clause of leasing company is to be studied to see that the goods like capital goods, consumer durables etc. in respect of which the company can undertake such activities and to ensure that whether company can undertake financing activities or not.

2. Whether there exists a procedure to ascertain the credit analysis of lessee like lessee's ability to meet the commitment under lease, past credit record, capital strength, availability of collateral security, etc.

3. The lease agreement should be examined and the following points may be noted.

- The description of the lessor, the lessee, the equipment and the location where the equipment is installed;
- the stipulation regarding the use of the equipment;
- the tenure of lease, due dates, late charges, security deposits etc.,
- Whether the equipment shall be returned to the lessor on termination of the agreement and the cost shall be borne by the lessee;
- Whether the agreement prohibits the lessee from subletting the equipment.

4. Examine the lease proposal form submitted by the lessee requesting the lessor to provide him the equipment on lease.

5. Ensure that the invoice is retained safely as the lease is a long-term contract.

6. Examine the acceptance letter obtained from the lessee indicating that the equipment has been received in order and is acceptable to the lessee.

7. See Board resolution authorising a particular director to execute the lease agreement has been passed by the lessee.

8. See that copies of the insurance policies have been obtained by the lessor for his records.

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Types of Lease Agreements

As per AS-19 lease arrangements could be of 2 types i.e. Finance Lease and Operating Lease.

a. **Finance Lease**: An arrangement with the following attributes qualifies as a Finance Lease:

1. Lease arrangement transfers ownership of the asset to the lessee at the end of the lease term;

2. Lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised;

3. Lease term is for the major part of the economic life of the asset even if title is not transferred;

4. At the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and

5. Leased assets are of such a specialized nature that only the lessee can use them without major modifications

b. **Operating Lease**: An arrangement that does not transfer substantially all the risks and rewards incidental to ownership qualifies as an Operating Lease. In other words, an operating lease is a lease arrangement "Other than finance lease".

Operating lease vs. Finance Lease

	Operating Lease	Financial Lease
Common examples	Lease of Computers, Laptops, Coffee Dispensers etc	Lease of Land, Building, Plant and Machinery etc.
Ownership of Assets	Remains with the lessor for the entire period of lease.	Ownership transfer option at end of lease period is with the lessee.
Accounting treatment	Operating lease is generally treated like a renting arrangement. Lease payments are treated as operating expenses and asset does not appear as an asset on lessee's balance sheet	Financial lease is treated like loan arrangement. Asset ownership is considered of that of the lessee and thus appears on the balance sheet of the lessee.
Purchase Option .	Lessee does not have any option to buy the asset during the lease period	Lessee have a purchase option at less than fair market value of asset.
Lease Term	Lease term generally extends to less than 75% of projected useful life of the leased asset.	Lease term is generally more than or equal to estimated economic life of the asset
Operating/ running expenses.	Lessee pays only monthly lease payments. No	Lessee generally bears insurance, maintenance taxes.

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	running cost are to be borne.	
Tax benefit	Operating lease is as good as renting, lease payment is considered as expense. No depreciation can be claimed by the lessee.	Lessee can claim both interest and depreciation expense as financial lease are treated like a loan.

Audit of Hotels

Internal Controls

- Pilfering is one of the greatest problems in any hotel and importance of internal control cannot be undermined. It is the responsibility of management to introduce controls which will minimize the leakage. Evidence of their success is provided by preparation of regular trading accounts for each sales point and a detailed scrutiny of resulting profit percentages, with any deviation from the anticipated.

- Auditor should obtain these regular trading accounts for the period under review, examine them and obtain explanations for any apparent deviations.

- Auditor should verify a few restaurant bills by reference to K.0.T.s (Kitchen Order Tickets) or basic record. This would enable him to ensure that controls regarding revenue cycle are in order

- Auditor should satisfy himself that all taxes collected from occupants on food and occupation have been paid over to the proper authorities.

Room Sales & Hall Bookings

- Charge for room sales is normally posted to guest bills by the receptionist/front office. Source of these entries is invariably the guest register and audit tests should be carried out to ensure that the correct numbers of guests are charged for the correct period. Any difference between the charged rates used on the guests' bills and the standard room rate should be investigated to ensure that they have been properly authorized.

- In many hotels, housekeeper prepares a daily report of the rooms which were occupied the previous night. This report tends not to be permanently retained and the auditor should ensure that a sufficient number of reports are available for him to test both with the guest register and with the individual guest's bill.

- Auditor should ensure that proper valuation of occupancy-in-progress at the balance sheet date is made and included in the accounts.

- Auditor should ensure that proper records are maintained for booking of halls and other premises for special parties and recovered on the basis of the tariff.

Inventories

- Inventories in any hotel are both readily portable and saleable particularly the food and beverage inventories. It is therefore extremely important that all movements and transfers of such inventories should be properly documented to enable control to be exercised over each individual store's areas and sales point. Auditor should carry out tests to ensure that all such documentation is accurately processed.

- Areas where large quantities of inventory are held should be kept locked, key being retained by departmental manager. Key should be released only to trusted personnel and unauthorized persons should not be permitted in the store's areas except under constant supervision.

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• Many hotels use specialized professional valuers to take and value the inventories on a continuous basis throughout the year. Such a valuation is then almost invariably used as the basis of the balance sheet inventory figure at the year-end. Auditor should satisfied himself that the amounts included for such inventories are reasonable. For this purpose, auditor should consider attending the physical inventory taking and carrying out certain pricing and calculation tests. The extent of such tests could well be limited since the figures will have been prepared independently of the hotel.

Travel Agents & Shops

• For ledgers coming through travel agents or other booking agencies, bills are usually made on the travel agents or booking agencies. Auditor should ensure that money are recovered from the travel agents or booking agencies as per the terms of credit allowed.

• Commission, if any, paid to travel agents or booking agents should be checked by reference to the agreement on that behalf.

Audit of Co-operative Societies

Background

Meaning of Co-operative Society

A business organization with a special mode of doing business, by pulling together all means of production co-operatively, elimination of middlemen and exploitation from outside forces.

Co-operative Societies Act, 1912

Central Act, containing the fundamental law regarding the formation and working of the co-operative societies in India and is applicable in many states with or without amendments. In many states, viz., Maharashtra, West Bengal, Orissa, the co-operative societies are governed by specific state Acts.

Role of Chartered Accountant

Apart from audit, some other professional services could be rendered by chartered accountants such as:

1) guidance in accounts writing

2) installation of accounting system,

3) internal audit,

4) management accounting services,

5) taxation etc.

Provisions Societies Law related with Audit

Section 17 of the Co-Operative Societies Act, 1912

1) Registrar shall audit or cause to be audited by authorized person, accounts of every registered society once at least in every year.

2) Audit shall include an examination of overdue debts, if any, and a valuation of the assets and liabilities of the society.

3) Registrar, Collector or any person authorized shall at all times have access to all books, accounts, papers and securities of a society, and every officer of the society shall furnish such information in regard to transactions and working of the society as the person making such inspection may require.

Important Provisions of Co-operative Societies Law

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Qualifications of Auditors

Apart from a CA within the meaning of the CA Act, 1949, some of the State Co-operative Acts have permitted persons holding a government diploma in co-operative accounts and accountancy as also a person who has served as an auditor in co-operative department of a government to act as an auditor.

Appointment of the Auditor

- An auditor of a co-operative society is appointed by the Registrar.
- Auditor so appointed conducts the audit on behalf of the Registrar and submits his report to him and also to the society.
- Audit fees is paid by the society on the basis of statutory scale of fees prescribed by the Registrar.

Books, Accounts and other records of Co-operative Societies

U/s 43(h) of Co-operative Societies Act, a state government can frame rules prescribing books and account to be kept by a co-operative society. For example, in Maharashtra, co-operative societies are required to maintain books of account for the following:

I. All sums of money received and expended by the society

II. All sales and purchases of goods by the society.

III. Assets and liabilities of the society

Society is at liberty to maintain such additional records according to its convenience and which it thinks fit more useful for clarity and detailed explanation. Examples of such additional records are:

a) Daily Cash Sales Summary Register

b) Register of Collection from Debtors in case of credit sales.

c) Register of recovery of loans from salaries and directly by receipts from members in case of credit society.

d) Loan disbursement register.

e) Any other columnar subsidiaries depending upon nature and functions.

Restrictions on share holdings

- Sec. 5 provides that in the case of a society where the liability of a member of the society is limited, no member of a society other than a registered society can hold such portion of share capital as would exceed a maximum of 20% of the total number of shares or of the value of shareholding to ₹ 1,000.

- Auditor will be concerned with this provision so as to watch any breach relating to holding of shares.

Restrictions on loans

- A registered society shall not make a loan to any person other than a member.

- With the special sanction of the Registrar, a registered society may make a loan to another registered society (Sec. 29).

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- State Government may further put such restrictions as it thinks fit on the loaning powers of the society to its members or to other societies.

Restrictions on borrowings

- A registered society may accept loans and deposits from its members and others subject to the restrictions and limits of bye-laws of the society.
- Auditor will have to examine bye-laws in this respect (Sec. 30).

Investment of funds

As per Sec. 32, a society may invest its funds in the following:

a) In the Central or State Co-operative Bank

b) In any of the securities specified in Sec. 20 of Indian Trusts Act, 1882.

c) In shares, securities, bonds or debentures of any other society with limited liability.

d) In any co-operative bank, other than a Central or State co-operative bank, as approved by the Registrar.

e) In any other moneys permitted by the Central or State Government.

Appropriation of profits

Sec. 33 states that a prescribed percentage of profits should be transferred to Reserve Fund, before distribution as dividends or bonus to members.

Contributions to Charitable purpose

As per Sec. 34, a registered society may, with the sanction of Registrar, contribute an amount not exceeding 10% of net profits remaining after the compulsory transfer to the reserve fund for any charitable purpose.

Investment of Reserve Fund

Some of the State Acts provide that a society may use the Reserve Fund:

a) In the business of a society, as working capital.

b) may invest as per provisions of the Act.

c) may be used for some public purposes likely to promote the object of the society

Auditor should ensure strict compliance with the State Act and Rules.

Contribution to Education Fund

- Some State Acts provide that every society shall contribute annually towards Education Fund of State Federal Society, at appropriate rate.
- Contribution to Education Fund is a charge on profits and not an appropriation.

Special Features of Audit

Examination of overdue debts

- Overdue debts for a period from 6 months to 5 years and more than 5 years will have to be classified and shall have to be reported by an auditor.
- A further analysis of overdue debts from viewpoint of chances of recovery will have to be made, and they will have to be classified as good or bad.

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- Auditor will have to ascertain whether proper provisions for doubtful debts is made and whether the same is satisfactory.

Overdue Interest

Overdue interest should be excluded from interest outstanding and accrued due while calculating profit.

Certification of Bad Debts

- Bad debts and irrecoverable losses before being written off against Bad Debts Funds, Reserve Fund etc. should be certified as bad debts or irrecoverable losses by the auditor where the law so requires.
- Where no such requirement exists, managing committee must authorize the write-off.

Valuation of Assets and Liabilities

- Regarding valuation of assets there are no specific provisions under the Act and as such due regard shall be had to the general principles of accounting and auditing conventions and standards adopted.
- Auditor will have to ascertain existence, ownership and valuation of assets. Fixed assets should be valued at cost less adequate provision for depreciation. The incidental expenses incurred in the acquisition and the installation expenses of assets should be properly capitalized.
- Current assets be valued at cost or market price, whichever is lower.
- Regarding liabilities, auditor should see that all known liabilities are brought into the account, and contingent liabilities are stated by way of a note.

Adherence to Co-operative Principles

- Auditor will have to ascertain, how far the objects, for which the co -operative organisation is set up, have been achieved.
- Assessment is not necessarily in terms of profits, but in terms of extending benefits to members who have formed the society.
- While auditing expenses, auditor should see that they are economically incurred and there is no wastage of funds.
- Principles of propriety audit should be followed for the purpose.

Observations of the Provisions of the Act and Rules

- Auditor is required to point out infringement with the provisions of Cooperative Societies Act and Rules and bye-laws.
- Financial implications of such infringements should be properly assessed by the auditor and should be reported.
- Some State Acts contain restrictions on payment of dividends, which should be noted by the auditor.

Verification of Members Register

Examination of entries in members pass books regarding the loan given and its repayments, and confirmation of loan balances is very much important to assure that the entries in the books of account are free from manipulation.

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Special report to the Registrar

During the course of audit, if auditor notices that there are some serious irregularities in working of society, he may report these special matters to the Registrar. Registrar on receipt of such a special report may take necessary action against the society.

Circumstances in which special report is required:

I. Personal profiteering by members of managing committee in transactions of society, which are detrimental to interest of society.

II. Detection of fraud relating to expenses, purchases, property and stores of the society.

III. Mis-management.

IV. In case of urban co-operative banks, disproportionate advances to vested interest groups, such as relatives of management, & deliberate negligence about recovery thereof

Cases of reckless advancing, where management is negligent about taking adequate security and proper safeguards for judging the credit worthiness of the party.

Audit classification of society

- After judgment on overall performance of society, auditor has to award a class to the society. This judgment is to be based on the criteria specified by the Registrar.
- If management is not satisfied about award of audit class, it can make an appeal to Registrar, and Registrar may direct to review the audit classification.
- Auditor should be very careful, while making a decision about the class of society.

Discussion of Draft Report with managing committee

- On conclusion of audit, auditor should ask the Secretary of society to convene a meeting of managing committee to discuss draft audit report.
- Audit report should never be finalized without discussion with managing committee.

Provisions of Multi State Co Operative Societies Act, 2002

Multi-State Co-operative Societies Act, 2002 applies to co-operative societies whose objects are not confined to one State.

Books of Accounts

Every multi state co-operative society shall keep books of account w.r.t.:

a) all sum of money received & expended;

b) all sales and purchases of goods;

c) assets and liabilities;

d) In case of Multi State Co-operative Society engaged in production, processing and manufacturing, particulars relating to utilization of materials or labour or other term of cost as specified in bye laws.

Provisions relating to Audit

Qualification of Auditors

Section 72 of the Multi-State Co-operative Societies Act, 2002 states that a

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- person who is a Chartered Accountant within the meaning of the Chartered Accountants Act, 1949 can only be
- appointed as auditor of multi-state co-operative society.

However, the following persons are not eligible for appointment as auditors of a multi-state co-operative society-

(a) A body corporate.

(b) An officer or employee of the multi-state co-operative society.

(c) A person who is a member or who is in the employment, of an officer or employee of the multi-state co-operative society.

(d) A person who is indebted to the multi-state co-operative society or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the Multi-State co-operative society for an amount exceeding one thousand rupees.

Appointment of Auditor - Sec. 70

First Auditor

First Auditor shall be appointed by

- BOD within one month of date of registration.
- If BOD fails, society may appoint first auditor at General meeting.

Auditor so appointed hold office till conclusion of first AGM

Subsequent Auditor

- Subsequent auditors are appointed at each AGM.
- Auditor so appointed hold office till conclusion of next AGM.

Power of Auditor - Sec. 73(1)

- Right of access at all times to the books, accounts and vouchers whether kept at the head office or elsewhere.
- Require from the officers or other employees, such information and explanation as the auditor may think necessary for the performance of the duties as an auditor.

Duties

Conduct Inquiry - Sec. 73 (2)

a) Whether loans & advances made on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to interests of the society or its members;

b) Whether transactions which are represented merely by book entries are not prejudicial to interest of Society;

c) Whether personal expenses have been charged to revenue account: and

d) Where it is stated in the books and papers that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.

Making Report

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a) Auditor shall make a report to members on:

- accounts examined by him;
- every Balance Sheet & Profit and Loss Account; &
- every other document required to be part or annexed to the balance- or profit and loss account,

which are laid before society in general meeting.

Report shall state whether, in his opinion and to the best of his information and according to explanations given to him. Said accounts give the information required by this Act in manner so required and give a true and fair view.

i) in case of balance-sheet, of the state of affairs as at the end of its financial year; and

ii) In case of profit and loss account, of the profit or loss for its financial year.

c) Auditor's report shall also state:

(i) Whether he has obtained all the information and explanation which to the best of his knowledge and belief were necessary for the purpose of his audit.
(ii) Whether, in his opinion, proper books of account have been kept, so far as appears from his examination and proper returns have been received from branches not visited by him.
(iii) Whether report on accounts of any branch office audited by a person other than auditor has been forwarded to him and how he has dealt with the same in preparing the auditor's report.
(iv)Whether balance sheet and profit and loss account are in agreement with books of account and return.

Powers of C.G. to order Special audit - Sec. 77

C.G. may pass an order, any time, for the special audit if they are of opinion that the:

I. affairs are not being managed in accordance with co-operative principles or prudent commercial practices or with sound business principles; or

II. society is being managed in a manner likely to cause serious injury or damage to the interests of the trade industry or business to which it pertains; or

III. Financial position is such as to endanger solvency of the society.

1. Central Government's Order :-The Central Government may at any time by order direct that a special audit of the Multi-State co-operative society's accounts for such period or periods as may be specified in the order shall be conducted.

2. **Appointment of the Auditor** :-It may appoint either a chartered accountant or the Multi-State co-operative society's auditor himself to conduct the special audit.

3**. Shareholding Restriction**

C.G. shall order for special audit only if that Govt. or State Government either by itself or both hold > 51% of the PUSC in such society.

Power and Duties

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Same as covered in Sec. 73 with the exception that the audit report will be submitted to Central Government instead of Society.

Action by the C.G.

- On receipt of report of special auditor, C.G. may take such action as it considers necessary.
- However, if no action taken within 4 months from date of its receipt, C.G. shall send to society, either a copy of, or relevant extract from, report with its comments thereon & require it either to circulate that copy or those extracts to members or to have such copy or extracts read before society at its next general meeting.

Expenses pertaining to Special Audit

Expenses of special audit shall be determined by the C.G. which determination shall be final and paid by the society & in default of such payment, shall be recoverable from the Society as an arrear of land revenue.

Inquiry by Central Registrar - Sec. 78

Circumstances when inquiry may be hold or ordered

Central Registrar may, on a request rom

- a federal cooperative to which multi-state cooperative society is affiliated; or
- a creditor; or
- not less than 1/3rd of the members of the board; or
- not less than 1/5th of the total number of members of a multi-state cooperative society

hold an inquiry or direct some person authorised by him by order in writing in this behalf to hold an inquiry into the constitution, working and financial condition of a multi-state cooperative society:

Opportunity of being heard

No inquiry shall be held unless a notice of not less than 15 days has been given to the multistate cooperative society.

Powers of person conducting inquiry

a) Free access to books, accounts, documents, securities, cash and other properties belonging to multi-state cooperative society;

b) Require officers of society to call a general meeting of society by giving notice of not less than 7 days at such time & at headquarters of society to consider such matters, as may be directed by him; and where officers refuse or fail to call such a meeting, he shall have power to call it himself;

c) Summon any person who is reasonably believed by him to have knowledge of affairs of society to appear before him at any place at headquarters of the society or any branch thereof and may examine such person on oath.

Follow up

Central Registrar shall, within a period of 3 months of the receipt of report, communicate the report of inquiry to society, financial institutions, if any, to which the society is affiliated, and to the person or authority, if any at whose instance the inquiry is needed.

Inspection - Sec. 79

When?

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Central Registrar may, on a request from

- a federal cooperative to which society is affiliated; or
- a creditor; or
- not less than 1/3rd of the members of the board: or
- not less than 1/5h of the total number of members of a multi-state cooperative society

How?

By general or special order in writing, inspect or direct any person authorized by him by order in writing in this behalf to make an inspection into constitution, working & financial condition of a multi-state cooperative society.

Opportunity of being Heard

No inspection shall be made unless a notice of not less than 15 days has been given to the multi-state cooperative society.

Powers of person conducting inspection

I. Access to all books, accounts, papers, vouchers, securities, stock & other property of that society and May, in the event of serious irregularities discovered during inspection, take them into custody.

II. Verify the cash balance of the society.

III. Call a meeting of board and also a general meeting of the society where such general meeting is, in his opinion, necessary.

Inspection Report

A copy of report of inspection shall be communicated to the society within a period of 3 months from the date of completion of such inspection.

Audit of Trust and Societies

Introduction

There are three basic legal forms of charitable entities under Indian law: trusts, societies, and section 8 companies. The legal framework governing the charitable institution will depend on the form of business organization the charitable institution takes.

- If the charitable institution is formed as a Public Trust, it will be governed by the Public Trust Act applicable in the relevant State. However, if no Public Trust Act exists in that state, then the applicable legislation will be the Indian Trusts Act, 1882.
- If the charitable institution is formed as a Society, it will be governed by the Societies Registration Act, 1860.
- The charitable institution can also be formed as a non-profit company under section 8 of the Companies Act, 2013.
- Apart from the above legislations, the Income Tax Act 1961 will be applicable to charitable institutions.
- And in the case of foreign contributions to these charitable institutions, the Foreign Contribution (Regulation) Act, 2010 will be applicable

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Books of Account

Auditor is required to report whether the Trust has maintained proper books of accounts, including the following, namely:

a) Cash book;

b) Ledger;

c) Journal;

d) copies of bills, whether machine numbered or otherwise serially numbered;

e) original bills wherever issued to the person and receipts in respect of payments made by the person;

f) any other book that may be required to be maintained in order to give a true and fair view of the state of the affairs of the person and explain the transactions effected.

Financial Statements

- Every year, trust has to prepare F.S. like Balance sheet and Income and expenditure statements.
- Format for preparation and presentation of F.S. is prescribed under respective state laws.

Auditor's responsibility

- Auditor should obtain list of books and records maintained by the Trust. List should be matched with requirement for maintaining mandatory books and records as may be applicable. Auditor should then verify records.
- Auditor is required to ensure compliance with Accounting Standards (AS) and Standards on Auditing (SA) prescribed and made mandatory by the ICAI.
- Auditor shall use his professional skill and expertise and apply such audit tests as the circumstances may require.
- Auditor shall conduct audit by applying generally accepted auditing procedures. He can apply test checks depending on evaluation of internal control procedures.

• Auditor shall also keep in mind concept of materiality.

• Auditor should keep detailed notes about the evidence on which he has relied upon and also maintain all his working papers.

Working papers should include notes on the following, amongst other matters:

a)	work done while conducting the audit and by whom;
b)	explanation and information given to him during audit and by whom;
c)	decision on various points taken;
d)	judicial pronouncements relied upon by him while drafting the audit report; and
e)	Certificates issued by the client/management letters.

Audit working papers shall provide evidence that:

a)	opinion expressed by the auditor is based on the examination made by him;
b)	in arriving at his opinion, auditor has given due cognizance to information and explanations given by the entity and that his opinion is not arbitrary;
c)	information and explanations obtained were full and complete; and

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d)	Auditor did not merely rely upon information or explanations given by the entity but that he subjected such information and explanations to reasonable tests to verify their accuracy and completeness.

Audit of Trust

The auditor has to ascertain

a) whether accounts are maintained regularly and in accordance with provisions of applicable Act and the rules;

b) Whether receipts and disbursements are properly and correctly shown in accounts and donations received is being applied as per objects of trust and specific direction by the donor, if any.

c) Whether all books, deeds, accounts, vouchers or other documents or records required by the auditor were produced before him;

d) Whether manager or trustee or any other person required by the auditor to appear before him did so and furnished the necessary information required by him;

e) Whether any property or funds of the Trust were applied for any object or purpose other than the object or purpose of the Trust;

f) Amounts of outstanding for more than one year and the amounts written off, if any;

g) Ascertain all cases of irregular, illegal or improper expenditure and whether such expenditure was caused in consequence of breach of trust or misapplication or any other misconduct on the part of the trustees;

h) Whether the maximum and minimum number of the trustees is maintained;

i) Whether minute books of the proceedings of the meeting is maintained;

j) Whether anonymous donations received are properly accounted for and donations in cash are not received by the Trust over and above the prescribed limit;

k) Whether the irregularities pointed out by the auditors in the accounts of the previous year have been duly complied with by the trustees during the period of audit;

l) Any special matter which the auditor may think fit or necessary to bring to the notice of the Deputy or Assistant Charity Commissioner.

Considerations while auditing a Society

a) Ascertain governing legislation of society i.e., Societies Registration act, 1860 or any applicable state law under which it has been registered.

b) Object of society needs to be ascertained from its memorandum of association/bye laws.

c) Ascertain whether registration obtained under FCRA, 2010 in case of foreign contributions.

d) Ascertain whether it is also registered under relevant provisions of Income-tax Act which may make it eligible for tax exemption on its income.

e) Obtain an understanding of internal control to design audit procedures with special reference to donations and various expenditures incurred.

f) Evaluate appropriateness of accounting policies with special reference to donations and grants.

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g) Ascertain, if any inquiry has been held by Registrar under applicable law in the working or financial condition of society and its implications for auditor's opinion.

h) Ascertain all cases of irregular, illegal or improper expenditure and check whether such expenditure was caused in consequence of breach of trust or misapplication or any other misconduct on the part of governing body.

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Chapter 15 : SA 700 – Forming an Opinion and Reporting on Financial Statements

Contents

- Scope of SA
- Financial Reporting Framework
- Opinion – Unmodified and Modified
- Consideration for forming an opinion
- Audit Report Elements

1.1 Introduction

An **Audit report** is an opinion drawn on the entity's financial statements to make sure that the records are true and fair representation of the transactions they claim to represent.

Management is responsible for preparation of Financial Statements. Auditor provides further confidence to intended users through Audit Report.

In order to form that opinion, the auditor shall conclude as to whether the auditor has **obtained reasonable assurance** about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error.

1.2 Scope of SA

- The auditor's responsibility to form an opinion on the financial statements to ensure financial statements reflect a true and fair representation
- The form and content of the auditor's report issued as a result of an audit of financial statements.

This SA applies to

- an audit of a complete set of general-purpose financial statements and is written in that context
- audits for which SA 800 or SA 805 apply.

General purpose financial statements – Financial statements prepared in accordance with a general-purpose framework.

This SA promotes consistency in the auditor's report, but recognizes the need for flexibility to accommodate particular circumstances of individual jurisdictions.

1.3 Objective of the Auditor

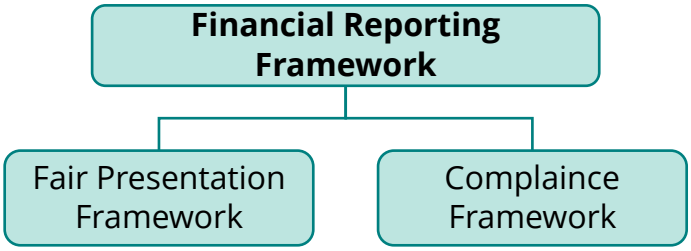
The objectives of the auditor are:

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- To **form an opinion** on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained; and
- To express clearly that opinion through a **written report**.

The auditor's report shall be in writing

1.4 Financial Reporting Framework



1.4.1 Fair Presentation Framework

Fair presentation framework requires compliance with the requirements of the framework and to make financial statements not misleading, requiring management to

- provide additional disclosures or
- depart from any material requirement of the reporting framework (exceptional cases)

1.4.2 Compliance Framework

Compliance framework refers to compliance of requirements to framework, without reference to additional disclosures and departures mentioned above.

1.5 Form an Opinion

Auditor's objective is to form an opinion on the financial statements after performing audit procedures. The auditor may express an unmodified opinion or a modified opinion

1.5.1 Unmodified Opinion

Unmodified opinion – The opinion expressed by the auditor when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

Unmodified or unqualified opinion indicates that

- FS are prepared on generally accepted accounting principles and comply with relevant statutory requirements
- Adequate disclosures are made

1.5.2 Modified Opinion

Modified Opinion is given if the auditor

- concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or

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- is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement, the auditor shall modify the opinion in the auditor's report in accordance with SA 705.

Fair Presentation Framework – If financial statements do not achieve fair presentation, auditor may, if necessary, give modified opinion after discussing with management
Compliance Framework – If financial statements are misleading, auditor shall determine how to communicate in the auditor's report after discussing with the management.

1.6 Considerations to form an opinion on Financial Statements

The auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

1.6.1 Preparation of Financial Statements

While ensuring that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework, auditor shall evaluate:

- Adequate disclosure of accounting policies, including notes to account are made
- Appropriateness of accounting policies
- Consistency in following accounting policies
- Reasonableness of accounting estimates made by management
- Information presented in the financial statements is relevant, reliable, comparable and understandable
- Effect of material transactions and events has been adequately disclosed
- Appropriate terminology is used
- Adequate reference to applicable financial reporting framework

When the financial statements are prepared in accordance with a fair presentation framework, evaluate whether the financial statements achieve fair presentation. procedures.

1.6.2 Reasonable Assurance

Obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement and in this regard shall consider:

- Whether sufficient appropriate evidence has been obtained.
- Whether uncorrected misstatements are material either individually or in aggregate.

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1.7 Elements of Audit Report

The auditor's report includes the following basic elements:

1.7.1 Title

Audit Report should have a title clearly stating that it is a report of an independent auditor.

1.7.2 Addressee

Audi Report is normally addressed to those for whom Audit Report is prepared, i.e. shareholders or TCWG.

1.7.3 Opinion

This section states the auditor's opinion on true and fair view of financial statements. Opinion Section of the Auditor's Report shall also cover the following:

- Identify the entity whose FS have been audited.
- State that Financial Statements have been audited.
- Identify title of each statement that comprises F.S.
- Refer to the notes, including the summary of significant accounting policies; and
- Specify date of period covered by each Financial Statement.

1.7.4 Basis for Opinion

The auditor's report shall include a section, directly following the Opinion section, with the heading "Basis for Opinion", that:

- States that the audit was conducted in accordance with SA;
- Refers to the section of the auditor's report that describes the auditor's responsibilities under the SAs;
- Includes a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit, and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements. The statement shall refer to the Code of Ethics issued by ICAI
- States whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

1.7.5 Going Concern

Where applicable, the auditor shall report in accordance with SA 570.

1.7.6 Key Audit Matters

The auditor shall communicate key audit matters in the auditor's report in accordance with SA 701

- for audits of complete sets of general-purpose financial statements of listed entities,
- for communications of key audit matters as per law or regulation

1.7.7 Other Information

Where applicable, auditor shall report in accordance with SA 720.

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1.7.8 Responsibilities of Management for the Financial Statements

- Preparing the financial statements in accordance with applicable financial reporting framework.
- Such internal control as management determines necessary to enable the preparation of financial statements that are free from material misstatements and error.
- Assessing the ability of the entity to continue as a going concern.
- Whether the use of the going concern assumption is appropriate.



This section will also identify those responsible for governance i.e. Those Charged with Governance

For Fair presentation framework, the auditor's report with respect to management responsibilities shall refer to "the preparation and fair presentation of these financial statements" or "the preparation of financial statements that give a true and fair view,"

Auditor cannot conclude that management has provided with all relevant information agreed in the terms of the audit engagement agreement without confirming with management whether such information has been provided.



If those who signed engagement letter are no more in the entity, new people in management can give the representations with respect to going concern.

1.7.9 Auditor's Responsibility

It shall state the auditor's objectives to

- obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error; and
- Issue an auditor's report that includes the auditor's opinion.

This section also enumerates the auditor's responsibilities as prescribed under different Standards on Auditing.

The auditor shall also mention that assurance is a high level of assurance but is not a guarantee that an audit conducted in accordance with SAs will always detect a material misstatement when it exists.

- The auditor shall state that, as part of an audit in accordance with SAs, the auditor exercises professional judgment and maintains professional scepticism throughout the audit and
- Describe an audit by stating that the auditor's responsibilities are to
  - Identify and assess risks of material misstatements
  - Design and perform audit procedures responsive to such risks
  - Obtain sufficient appropriate audit evidence
  - Risk of not detecting material misstatement is higher for fraud than error
  - Obtain understanding of internal control for designing audit procedures but not for forming opinion on their effectiveness

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- Evaluate appropriateness of accounting policies and reasonableness of accounting estimates
- Conclude on appropriateness of management's use of going concern basis
- Evaluate overall presentation, structure and content of the financial statements for fair presentation framework

- The auditor shall describe the responsibilities in a group audit by stating the extent to which financial information of components have been audited by other auditors.
- The auditor shall also state the manner in which the auditor communicated with those charged with governance with respect to
  - Planned scope and timing of the audit
  - Significant audit findings
  - Significant deficiencies in internal controls.
- The matters communicated as Key Audit Matters are those matters which the auditor considers to be of most significance out of the matters which are communicated to those charged with governance.

Location of the Description of Auditor's Responsibilities

The description of the auditor's responsibilities shall be included

- within the body of the auditor's report or
- within an appendix to the audit report (with reference to the same in the auditor's report) or
- on a website of an appropriate authority if law permits (with specific reference in the audit report).

1.7.10 Other Reporting Responsibilities

If the auditor addresses other reporting responsibilities in the auditor's report on the financial statements that are in addition to the auditor's responsibilities under the SAs, these other reporting responsibilities shall be addressed in a separate section in the auditor's report with a heading titled "Report on Other Legal and Regulatory Requirements"

1.7.11 Signature of the Auditor

Audit report to be signed in auditor's (engagement partner) personal name. Where firm appointed as auditor, report is signed in personal name of the auditor and in the name of audit firm.

The partner/proprietor signing the audit report also needs to mention the membership number assigned by

1.7.12 Place of Signature

It is ordinarily the city where audit report is signed i.e. the Corporate office of the entity.

1.7.13 Date of Auditor's Report

It should not be earlier than the date on which auditor has obtained sufficient appropriate audit evidence (on which auditor's opinion is based) that:

- financial statements, including the related notes, have been prepared; and

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- those with authority have acknowledged that they have taken responsibility for those financial statements.

1.8 Audit Reports prescribed by Law

If the auditor is required by law or regulation to use a specific layout, or wording of the auditor's report, the auditor's report shall refer to Standards on Auditing only if the auditor's report includes, at a minimum, each of the following elements:

- Title
- Addressee
- Opinion
- Identification of entity's financial statements
- Statement on auditor's independence
- Going Concern issue, where applicable (SA 570)
- Key Audit Matters (SA 701)
- Auditor's Responsibilities (SA 720)
- Responsibilities of Management for preparation of Financial Statements (SA 700)
- Reference to SAs
- Auditor's Responsibilities
- Auditor's Signature
- Place & Date of Audit Report

1.9 Audit Report for audits conducted in accordance with SAs issued by ICAI and International SAs

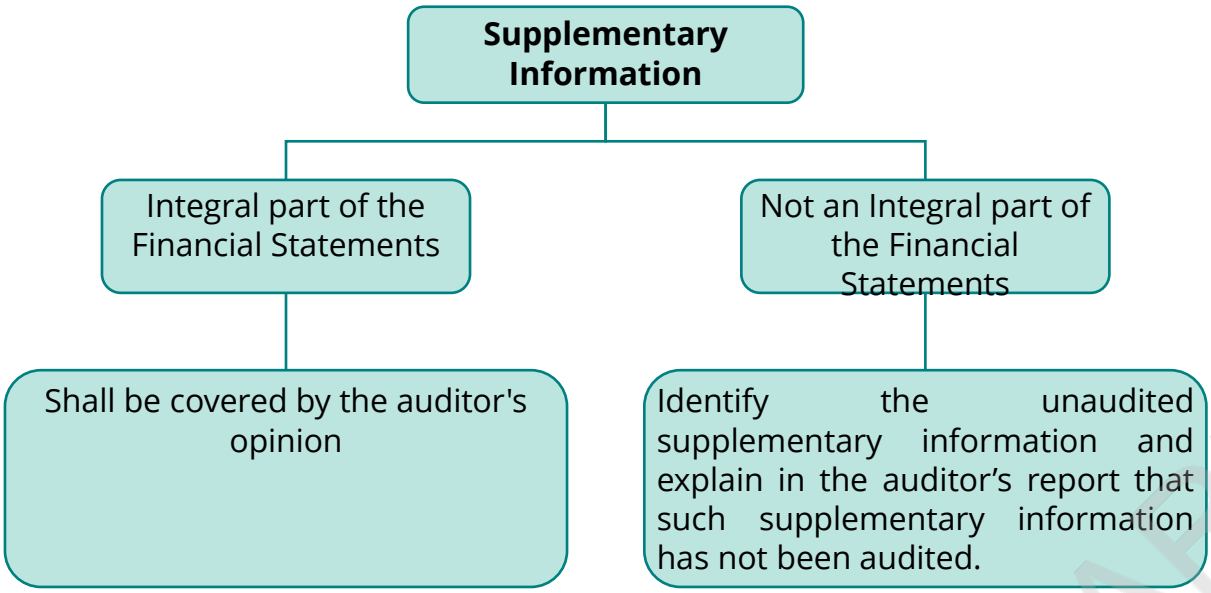
The auditor's report may refer to SAs in addition to the International SAs or auditing standards of such other jurisdiction only if:

- No conflict between SAs and ISAs leading to formation of different opinions or including Emphasis or Other Matters paragraph
- The auditor's report includes the minimum elements in the report.

When the auditor's report refers to both the ISAs and SAs issued by ICAI, the auditor's report shall clearly identify the same including the jurisdiction of origin of the other auditing standards.

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1.10 Supplementary information presented with the Financial Information



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1.11 Format of an Audit Report

To the Members of ABC Company Limited

Report on the Audit of the Standalone Financial Statements

Opinion

We have audited the standalone financial statements of ABC Company Limited ("the Company"), which comprise the balance sheet as at 31st March 20XX, and the statement of Profit and Loss, (statement of changes in equity)2 and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies and other explanatory information [in which are included the Returns for the year ended on that date audited by the branch auditors of the Company's branches located at (location of branches)].

In our opinion and to the best of our information and according to the explanations given to us, the aforesaid standalone financial statements give the information required by the Act in the manner so required and give a true and fair view in

conformity with the accounting principles generally accepted in India, of the state of affairs of the Company as at March 31, 20XX, and profit/loss, (changes in equity)4 and its cash flows for the year ended on that date.

Basis for Opinion

We conducted our audit in accordance with the Standards on Auditing (SAs) specified under section 143(10) of the Companies Act, 2013. Our responsibilities under those Standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the Company in accordance with the Code of Ethics issued by the Institute of Chartered

Accountants of India together with the ethical requirements that are relevant to our audit of the financial statements under the provisions of the Companies Act, 2013 and the Rules thereunder, and we have fulfilled our other ethical responsibilities in

accordance with these requirements and the Code of Ethics. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

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Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

[Description of each key audit matter in accordance with SA 701.]

Management's Responsibility for the Standalone Financial Statements

The Company's Board of Directors is responsible for the matters stated in section 134(5) of the Companies Act, 2013 ("the Act")4 with respect to the preparation of these standalone financial statements that give a true and fair view of the financial position, financial performance, (changes in equity)5 and cash flows of the Company in accordance with6 the accounting principles generally accepted in India, including the accounting Standards specified under section 133 of the Act. This responsibility also includes maintenance of adequate accounting records in accordance with the provisions of the Act for safeguarding of the assets of the Company and for preventing and detecting frauds and other irregularities; selection and application of appropriate implementation and maintenance of accounting policies; making judgments and estimates that are reasonable and prudent; and design, implementation and maintenance of adequate internal financial controls, that were operating effectively for ensuring the accuracy and completeness of the accounting records, relevant to the preparation and presentation of the financial statement that give a true and fair view and are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

Those Board of Directors are also responsible for overseeing the Company's financial reporting process.

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Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with SAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

Other Matter

We did not audit the financial statements/ information of__(number) branches included in the stand alone financial statements of the Company whose financial statements/financial information reflect total assets of Rs _____as at 31st March 20XX and the total revenue of _____for the year ended on that date, as considered in the standalone financial statements/information of these branches have been audited by the branch auditors whose reports have been furnished to us, and our opinion in so far as it relates to the amounts and disclosures included in respect of branches, is based solely on the report of such branch auditors.

Our opinion is not modified in respect of these matters.

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Report on Other Legal and Regulatory Requirements

As required by the Companies (Auditor's Report) Order, 2016 ("the Order"), issued by the Central Government of India in terms of sub-section (11) of section 143 of the Companies Act, 2013, we give in the Annexure a statement on the matters specified in paragraphs 3 and 4 of the Order, to the extent applicable.

As required by Section 143(3) of the Act, we report that:

(a) We have sought and obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purposes of our audit.

(b) In our opinion, proper books of account as required by law have been kept by the Company so far as it appears from our examination of those books [and proper returns adequate for the purposes of our audit have been received from the branches not visited by us]

(c) [The reports on the accounts of the branch offices of the Company audited under Section 143(8) of the Act by branch auditors have been sent to us and have been properly dealt with by us in preparing this report.]

(d) The Balance Sheet, the Statement of Profit and Loss, and the Cash Flow Statement dealt with by this Report are in agreement with the books of account [and with the returns received from the branches not visited by us].

(e) In our opinion, the aforesaid standalone financial statements comply with the Accounting Standards specified under Section 133 of the Act, read with Rule 7 of the Companies (Accounts) Rules, 2014.

(f) On the basis of the written representations received from the directors as on 31st March, 20XX taken on record by the Board of Directors, none of the directors is disqualified as on 31st March, 20XX from being appointed as a director in terms of Section 164 (2) of the Act.

(g) With respect to the adequacy of the internal financial controls over financial reporting of the Company and the operating effectiveness of such controls, refer to our separate Report in "Annexure A".

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(h) With respect to the other matters to be included in the Auditor's Report in accordance with Rule 11 of the Companies (Audit and Auditors) Rules, 2014, in our opinion and to the best of our information and according to the explanations given to us:

(i) The Company has disclosed the impact of pending litigations on its financial position in its financial statements – Refer Note XX to the financial statements; [or the Company does not have any pending litigations which would impact its financial position]

(ii) The Company has made provision, as required under the applicable law or accounting standards, for material foreseeable losses, if any, on long- term contracts including derivative contracts – Refer Note XX to the financial statements; [or the Company did not have any long-term contracts including derivative contracts for which there were any material foreseeable losses.]

(iii) There has been no delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the Company {or, following are the instances of delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the Company or there were no amounts which were required to be transferred to the Investor Education and Protection Fund by the Company.

For XYZ & Co

Chartered Accountants (Firm's Registration No.)

Signature

(Name of the Member Signing the Audit Report)

(Designation)

(Membership No. XXXXX)

Place of Signature:

Date:

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1.12 Questions

1) State correct or not

- Where the firm of appointed as an auditor of the entity the audit report is signed only in the name of audit firm. [May 19 (2 Marks)]
- Any partner of an LLP, who is appointed as an auditor of a company, can sign the audit report. [Nov. 18 (2 Marks)]

2) In order to form the audit opinion as required by SA 700, the auditor shall conclude as to whether the auditor has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. Explain the conclusions that the auditor shall take into account. Also explain the objective of auditor as per SA 700. [MTP-Aug. 18]
3) "An auditor is required to make specific evaluations while forming an opinion in an audit report." State them. [Nov. 18 (5 Marks)]
4) The auditor's report shall include a section with a heading "Responsibilities of Management for the Financial Statements." SA 200 explains the premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit in accordance with SAs is conducted. Explain. [RTP-Nov. 18, MTP-April 19]
5) When does an auditor issue unqualified opinion and what does it indicate? [May 08 (4 Marks)]
6) The Auditor is fully satisfied with the audit of an entity in respect of its systems and procedures and wants to issue a report without any hesitation. What type of opinion can be given and give reasoning? [MTP-April 19]
7) State any six elements of the Auditor's Report. [Nov. 12 (6 Marks)]
8) The auditor's report shall include a section, directly following the Opinion section, with the heading "Basis for Opinion". Explain what is included in this "Basis for Opinion" section. [RTP-Nov. 19]
9) The first section of the auditor's report shall include the auditor's opinion, and shall have the heading "Opinion." The Opinion section of the auditor's report shall also Identify the entity whose financial statements have been audited. Apart from the above, explain the other relevant points to be included in opinion section. [RTP-May 20]

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Chapter 16 : SA 701 – Communicating Key Audit Matters in the Independent Auditor's Report

Contents

- Scope of SA
- Key Audit Matters
- Communication of KAM
- Reporting KAM
- Documentation

2.1 Introduction

This SA deals with the auditor's responsibility to communicate key audit matters in the auditor's report.

- It is intended to address both the auditor's judgment as to what to communicate in the auditor's report and the form and content of such communication.
- Communicating key audit matters provides additional information to intended users of the financial statements ("intended users") to assist them in understanding those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period.

2.1.1 Objectives of Auditor under this SA

The objectives of the auditor are to determine key audit matters and, having formed an opinion on the financial statements, communicate those matters by describing them in the auditor's report.

2.1.2 Applicability of SA

- This SA applies to audits of complete sets of general-purpose financial statements of listed entities and circumstances when the auditor otherwise decides to communicate KAM in the auditor's report.
- This SA also applies when the auditor is required by law or regulation to communicate KAM in the auditor's report.

SA 705 (Revised) prohibits the auditor from communicating KAM when the auditor disclaims an opinion on the financial statements, unless such reporting is required by law or regulation

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2.2 Key Audit Matters (KAM)

Key Audit Matters - Those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance.

2.2.1 Determination of KAM

The auditor shall determine, from the matters communicated with TCWG, those matters that required significant auditor attention in performing the audit. In making this determination, the auditor shall consider the following:

- Areas of higher assessed RMM, or significant risks identified as per SA 315;
- Significant auditor judgments that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty.
- The effect on the audit of significant events or transactions that occurred during the period.

The auditor shall determine which of the matters so determined above were of most significance in the audit of the F.S. of the current period and therefore are the key audit matters.

2.3 Communication of Key Audit Matter

2.3.1 Audit Report

- Communicating KAM in the auditor's report is in the context of the auditor having formed an opinion on the financial statements as a whole (of the current period).



Key Audit Matters cannot be a substitute for expressing a Modified Opinion

2.3.2 Not a Substitute

- Communicating KAM in the auditor's report is not
  - A substitute for disclosures in the financial statements that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation;
  - A substitute for the auditor expressing a modified opinion when required by the circumstances of a specific audit engagement in accordance with SA 705 (Revised);
  - A substitute for reporting in accordance with SA 570 (Revised) when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern; or
  - A separate opinion on individual matters.



Modified opinion para comes before this para in audit report.

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2.3.3 Individual Description & Reference to Related Disclosures

The auditor shall describe each key audit matter, using an appropriate subheading, in a separate section of the auditor's report under the heading "Key Audit Matters,"

The description of each key audit matter in the KAM section of the auditor's report shall include a **reference to the related disclosure(s),** if any, in the financial statements and shall address:

- Why the matter was considered to be one of most significance in the audit and therefore determined to be a key audit matter; and
- How the matter was addressed in the audit

2.3.4 Circumstances where KAM is not communicated

The auditor shall not describe a key audit matter in the auditor's report if:

- Law or regulation prevents public disclosure about the matter; or
- In extremely rare circumstances, the auditor determines that the matter should not be communicated in the auditor's report because its benefits are lesser than the possible damages. This shall not apply if the entity has publicly disclosed information about the matter. [auditors generally don't apply this]

2.4 Significant matters not reported under "Key Audit Matters" but as Other Elements in the Audit Report

A matter giving rise to a

- modified opinion in accordance with SA 705 (Revised), or
- matters raising going concern questions SA 570 (Revised), are by their nature key audit matters.

Are significant matters and can come under the description of KAM, however these matters shall not be described in the Key Audit Matters section of the auditor's report. Rather, the auditor shall:

- Report on these matter(s) in accordance with the applicable SA(s); and
- Include a reference to the Basis for Qualified (Adverse) Opinion or the Material Uncertainty Related to Going Concern section(s) in the Key Audit Matters section.

2.5 No Key Audit Matters to report

If the auditor determines, depending on

- the facts and circumstances of the entity and
- the audit,

that there are no key audit matters to communicate, the auditor shall include a statement to this effect in a separate section of the auditor's report under the heading "Key Audit Matters."

When there are no KAM to report, auditor shall state the fact in the report

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In case of Disclaimer of Opinion, there wouldn't be any Key Audit Matters to report

Communication with Those Charged With Governance

The auditor shall communicate with those charged with governance:

- Those matters the auditor has determined to be the key audit matters; or
- The fact that there is no key audit matter to communicate in the auditor's report

2.6 Documentation

The auditor shall include in the audit documentation

- The matters that required significant auditor attention and whether it was considered as a key audit matter or not
- Reason for not considering KAM
- Reasons why matters were considered key audit matters and
  - why they were reported OR
  - not reported in the audit report

2.7 Questions

Communicating Key Audit Matter is not a substitute for disclosure in the Financial Statements rather Communicating key audit matters in the auditor's report is in the context of the Auditor having formed an opinion on the financial statements as a whole. Analyse. [RTP-May 18]

Explain clearly the purpose of communicating key audit matters. [RTP-Nov. 18]

Mr. A was appointed as statutory auditor of X Ltd. While doing audit, Mr. A is required to determine the key audit matters which are required to be mentioned in the audit report. You are required to advise Mr. A about the considerations which Mr. A shall take into account while determining key audit matters.

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Chapter 17 : SA 705 – Modifications to the Opinion in the Independent's Auditor's Report

Contents

- Modified Opinion
- Types – Qualified, Adverse, Disclaimer
- When to issue modified opinion

3.1 Scope

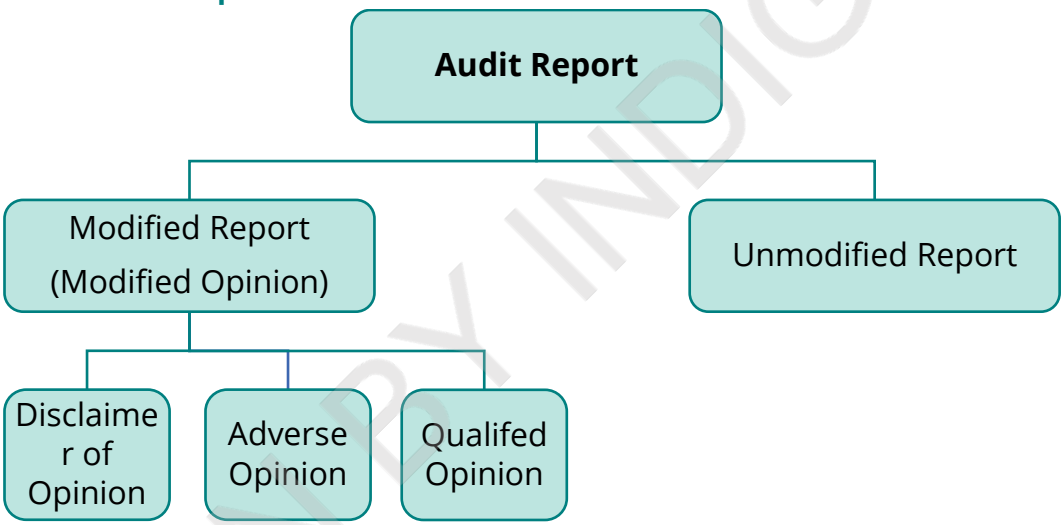
Auditor needs to follow this SA if a modification is required to the opinion. This SA also specifies the form and content

3.1.1 Objectives of the Auditor

Express clearly a modified opinion when

- Financial statements are not free of material misstatement
- Auditor unable to obtain sufficient appropriate audit evidence to conclude financial statements are free from material misstatements

3.2 Audit Report

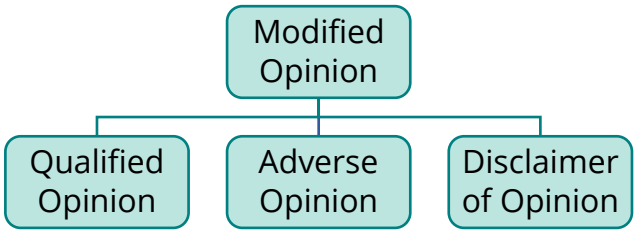


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3.3 Modified opinion

A qualified opinion, an adverse opinion or a disclaimer of opinion on the financial statements is a Modified Opinion

3.3.1 Types of Modified Opinion



Any opinion other than clean opinion is called modified – It could be Emphasis of matter as discussed in SA 706 or it could be Qualified, Adverse and Disclaimer as discussed in SA 705

3.3.2 Factors affecting the opinion

The decision regarding which type of modified opinion is appropriate depends upon:

- The nature of the matter giving rise to the modification i.e
  - the financial statements are materially misstated or,
  - no sufficient appropriate audit evidence leading to materially misstated financial statements
- The auditor's judgment about the pervasiveness of the effects or possible effects of the matter on the financial statements

3.3.3 When to modify the opinion

- Auditor concludes that financial statements are not free of material misstatement
- Auditor unable to obtain sufficient appropriate audit evidence to conclude financial statements are free from material misstatements

3.4 Persuasive

A term used, in the context of misstatements, to describe the effects or the possible effects of misstatements (if any) on the financial statements as a whole that are undetected due to an inability to obtain sufficient appropriate audit evidence.

Persuasive effects are those that are:

- not confined to specific elements, accounts or items of the financial statements
- If so confined, represent or could represent a substantial proportion of the financial statements
- In relation to disclosures, such disclosures are fundamental to users' understanding of the financial statements

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3.5 Modification in the Audit Report

Auditor determines the appropriate opinion depending on how material or pervasive the issues identified during the audit are to the reader's understanding of the financial statements

Nature of Matter Giving Rise to the Modification	Auditor's Judgment about the Pervasiveness of the effects or possible effects on the Financial Statements	
	Material but Not Pervasive	Material and Pervasive
Financial statements are materially misstated	Qualified opinion	Adverse opinion
Inability to obtain sufficient appropriate audit evidence	Qualified opinion	Disclaimer of opinion

3.6 Qualified Opinion

The auditor shall express a qualified opinion when:

a. The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements are material, individually or in the aggregate, but not pervasive, to the financial statements; or

Reasons for qualification to be mentioned in the

b. The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive

3.6.1 When to Give a Qualified Opinion

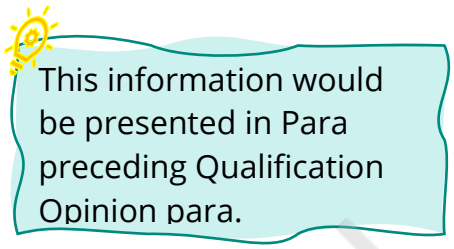
- Limitation of Scope
- Disagreement with management
  - Accounting policies or its application
  - Disclosure
  - Statutory Compliance
- Significant uncertainty (Other than going concern)
  - If Material – Qualified report
  - If not material – Emphasis of matter para
- Unable to obtain all information and explanations
- Proper books not kept in accordance with law

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- Balance Sheet and profit and Loss statement not in agreement with Books of account
- Information required by law not disclosed
- Accounts do not give true and fair view

3.6.2 Quantification of Impact

- Quantify the impact that qualification would have on the Financial statements.
- If accurate quantification is not possible, the basis and management assumptions that went into quantification need to be indicated.



3.7 Adverse Opinion

The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements

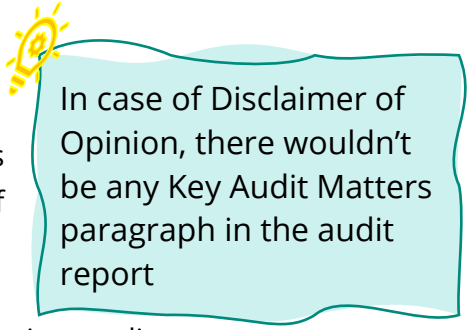
3.7.1 When to give an Adverse Opinions

- Scope of audit is restricted,
- The auditor may not have access to the books of accounts, e.g.: -
  - books of A/c's of the company seized by IT authorities,
  - Sometimes inventory verifications at locations outside the city bound the scope of duties of the auditor.

3.8 Disclaimer of Opinion

The auditor shall disclaim an opinion when

- the auditor is unable to obtain sufficient appropriate audit evidence and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could **be both material and pervasive.**



- If in case of **multiple uncertainties**, though sufficient appropriate audit evidence is obtained for each uncertainty individually, it is **not possible to form an opinion** on the financial statements due to the potential interaction of the uncertainties and their possible cumulative effect on the financial statements

When the auditor disclaims an opinion due to an inability to obtain sufficient appropriate audit evidence, the auditor shall amend the introductory paragraph of the auditor's report.

The auditor shall also amend the description of the auditor's responsibility and the description of the scope of the audit to state only the following:

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"Our responsibility is to express an opinion on the financial statements based on conducting the audit in accordance with Standards on Auditing issued by the Institute of Chartered Accountants of India. Because of the matter(s) described in the Basis for Disclaimer of Opinion paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion".

3.9 Reasons for Misstatement

- The appropriateness of the selected accounting policies
- The application of the selected accounting policies
- The appropriateness or adequacy of disclosures in the financial statements.

3.10 Reasons for Inability to obtain sufficient and appropriate audit evidence

- Circumstances beyond the control of the entity
- Circumstances relating to the nature or timing of the auditor's work
- Limitations imposed by management
  - Auditor may resign from the audit in such case OR
  - Issue a Disclaimer of opinion explaining scope limitation
  - Communicate matters relating to resignation to regulatory authorities and members / owners, if required by laws governing the enterprise

3.11 Form and Content of the Auditor's Report for a Modified Opinion

- Include additional paragraph indicating basis / reason for modification to the report format discussed in SA 700
- Such para shall be placed just before opinion paragraph with an appropriate heading "Basis for Qualified Opinion", "Basis for Adverse Opinion", or "Basis for Disclaimer of Opinion"

For Opinion paragraph, indicate heading appropriately ""Qualified Opinion", "Adverse Opinion", or "Disclaimer of

Quantify and indicate the impact of such modification on the financial statements. If it is impracticable to quantify the impact of modification, indicate the fact that the same couldn't be quantified.

- In short, Even if the auditor has expressed an adverse opinion or disclaimed an opinion on the

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financial statements, the auditor shall describe in the basis for modification paragraph the reasons for any other matters of which the auditor is aware that would have required a modification to the opinion, and the effects thereof

3.12 Communication with Those Charged with Governance

When the auditor expects to modify the opinion in the auditor's report, the auditor shall communicate with those charged with governance the circumstances that led to the expected modification and the proposed wording of the modification.

3.13 Questions

1) What is a qualified auditor report? Under what circumstances a qualified report is issued. [May 07 (8 Marks)]
2) What is clean audit report. Explain how it is different from qualified report affecting Auditor's opinion. [Nov. 07 (8 Marks)]
3) State briefly the circumstances when an auditor issues a disclaimer of opinion. [Nov. 10 (4 Marks)]
4) Differentiate between `Qualified Report' and `Adverse Report'. [May 10 (5 Marks)]
5) State the circumstances which could lead to any of the following in an Auditor's Report:
   (i) A modification of opinion
   (ii) Disclaimer of opinion
   (iii) Adverse opinion
   (iv) Qualified opinion [May 13 (8 Marks)]
6) Discuss the following: The Auditor's Report is considered to be modified under certain circumstances. [May 15 (5 Marks)]
7) Write short note on: Qualified Opinion. [Nov. 15 (4 Marks)]

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Chapter 18 : SA 706 - Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report

Reason for the paragraphs – Objective of the Auditor

Draw user's attention to

- matters presented or disclosed in the financial statements that are fundamental to users' understanding of the financial statements; or
- matters not presented or disclosed in the financial statements but are relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

Emphasis of Matter

A paragraph included in the auditor's report that refers to a matter appropriately **presented or disclosed** in the financial statements that, in the auditor's judgment, is of such importance that it is **fundamental to users' understanding** of the financial statements.

Factors affecting

The auditor shall include Emphasis of Matter only if

- It does not result in modified opinion
- It is not key audit matter

Reporting Aspects

- Include it immediately after opinion para of audit report
- Contain a heading "Emphasis of matter"
- Indicate clear reference to the disclosures of financial statements
- Indicate that the auditor's opinion is not modified in respect to matter emphasized

Circumstances for Emphasis of Matter

- An uncertainty relating to the future outcome of an exceptional litigation or regulatory action.
- Early application (where permitted) of a new accounting standard that has a pervasive effect on the financial statements in advance of its effective date.
- A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.



Inclusion of an Emphasis of Matter paragraph in the auditor's report does not affect the auditor's opinion.

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Other Matters

A paragraph included in the auditor's report that refers to a matter **other than those presented or disclosed** in the financial statements that, in the auditor's judgment, is **relevant to users' understanding** of the audit, the auditor's responsibilities or the auditor's report.

Include it immediately after opinion para of audit report or any Emphasis of matter

Factors affecting

The auditor shall include Emphasis of Matter only if

- It is not prohibited by law or regulation
- It is not key audit matter

Communicate with Those Charged with Governance

If the auditor expects to include an Emphasis of Matter or an Other Matter paragraph in the auditor's report, the auditor shall communicate with those charged with governance regarding this expectation and the wording of this paragraph.

Emphasis of Matters (EM) vs Key Audit Matters (KAM)

The use of Emphasis of Matter paragraphs is not a substitute for a description of individual key audit matters.

There may be a matter that is not determined to be a key audit matter in accordance with SA 701 (i.e., because it did not require significant auditor attention), but which, in the auditor's judgment, is fundamental to users' understanding of the financial statements (e.g., a subsequent event).

If the auditor considers it necessary to draw users' attention to such a matter, the matter is included in an Emphasis of Matter paragraph in the auditor's report in accordance with this SA.

Requirement under SAs

Emphasis of Matters

- SA 210, Agreeing the Terms of Audit Engagements
- SA 560, Subsequent Events
- SA 800, Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks

Other Matters

- SA 560, Subsequent Events
- SA 710, Comparative Information—Corresponding Figures and Comparative Financial Statements

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Format

Emphasis of Matter

We draw attention to Note X to the financial statements, which describe the uncertainty6 related to the outcome of the lawsuit filed against the Company by XYZ Company. Our opinion is not qualified in respect of this matter.

Other Matters

We did not audit the financial statements of certain subsidiaries; whose financial statements reflect total assets (net) of Rs. XXXX as at March 31, 20XX, total revenues of Rs. XXXX and net cash outflows amounting to Rs. XXXX for the year then ended. These financial statements have been audited by other auditors whose reports have been furnished to us by the Management, and our opinion is based solely on the reports of the other auditors. Our opinion is not qualified in respect of this matter

Questions

1) What is Emphasis of matter Paragraph? State the circumstances when EOM para can be included in Auditor's report
2) What is Modified Reports? Discuss disclosure pattern when the auditor includes an Emphasis of Matter Paragraph in the Auditor's Report. [May 14 (5 Marks)]
3) What is an Emphasis of Matter paragraph, when it is used and manner of its use in an audit report? [May 17 (4 Marks)]
4) Define emphasis of matter paragraph and how it should be disclosed in the independent auditor's report? [May 18 (5 Marks)]
5) Define Emphasis of Matter paragraph. When the auditor shall include an Emphasis of Matter paragraph in the auditor's report? Also explain how the auditor would include an Emphasis of Matter in the auditor's report? [RTP-May 19]

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