The Company Audit

Question 1

X Limited, a newly incorporated company in India commenced its business from April 1, 2015. The Company purchased fixed assets costing ₹ 4,000 lakhs on 01-04-2015 and the same was fully financed by foreign currency loan (U.S. Dollars) payable in three annual equal installments. Exchange rates were 1 Dollar = ₹ 40.00 and ₹ 42.50 as on 01-04-2015 and 31-03-2016 respectively. The company worked out foreign exchange loss as per AS 11 at ₹ 250 Lakhs and expensed the entire amount in the Statement of Profit and Loss. The Managing Director of the company was worried about this heavy revenue loss and asked the accountant not to follow AS 11 issued by the ICAI for this particular transaction. The Accountant of the company, followed the instruction of the Managing Director and removed exchange loss from the Statement of Profit and Loss but then he added the entire exchange loss to the value of fixed asset and computed the depreciation thereon. As an Auditor of X Limited how you would deal with this particular transaction?

Answer

Treatment of Changes in Foreign Exchange Rates: As per Para 46A(1) of AS 11 “The Effects of Changes in Foreign Exchange Rates” inserted by Ministry of Corporate Affairs by way of notification, the exchange differences arising on reporting of long - term foreign currency monetary items in so far as they relate to the acquisition of a depreciable capital asset, in respect of accounting periods commencing on or after the 1st April, 2011, can be added to or deducted from the cost of the asset and shall be depreciated over the balance life of the asset, and in other cases, it can be accumulated in a “Foreign Currency Monetary Item Translation Difference Account” in the enterprise’s financial statements and amortized over the balance period of such long term asset or liability, by recognition as income or expense in each of such periods.

Thus, X Ltd. has the choice to avail this option. However, the company should disclose the fact of such option and of the amount remaining to be amortized in the financial statements of the period in which such option is exercised and in every subsequent period so long as any exchange difference remains unamortized.

Question 2

Excellent Limited, a Company incorporated in India and listed with SEBI, has a scheme for payment of settlement allowance to retiring employees. Under the scheme, retiring employees are entitled to reimbursement of certain travel expenses for class they are entitled to as per company rules and regulations. Employees are also entitled to claim a lump-sum payment to
cover expenses on food and stay during the travel. The Company also gives option to employees that they can claim a lump-sum amount equal to three months pay last drawn.

Excellent Limited have following accounting policies to record these travel expenses:

(i) Settlement allowance does not depend upon the length of service of employee. It is restricted to employee’s eligibility under the travel rule of the company therefore all travel expenses fall under the category of defined contribution plans.

(ii) Since it is not related to the length of service of the employees, it is difficult to estimate reliably and there is no present obligation to pay employees as per AS 29 "Provisions, Contingent Liabilities and Contingent Assets", hence it is accounted for on claim basis.

You are statutory auditor of Excellent Limited. What would be your guidance to audit team?

**Answer**

**Treatment of Employee Benefits Expenses:** The present case falls under the category of defined benefit scheme under AS 15 “Employee Benefits”. The said scheme encompasses cases where payment promised to be made to an employee at or near retirement presents significant difficulties in the determination of periodic charge to the statement of profit and loss. The contention of the Company that the settlement allowance will be accounted for on claim basis is not correct even if company’s obligation under the scheme is uncertain and requires estimation. In estimating the obligation, assumptions may need to be made regarding future conditions and events, which are largely outside the company’s control. Thus,

(i) Settlement allowance payable by the company is a defined retirement benefit, covered by AS 15.

(ii) A provision should be made every year in the accounts for the accruing liability on account of settlement allowance. The amount of provision should be calculated according to actuarial valuation.

(iii) Where, however, the amount of provision so determined is not material, the company can follow some other method of accounting for settlement allowances.

**Question 3**

X Ltd is engaged in the business of newspaper and radio broadcasting. It operates through different brand names. During FY 15-16 it incurred substantial amounts on external trade, business communication and branding expenses by participation in various corporate social responsibility initiatives. The company expects to benefits by this expenditure by attracting new customers over a period of time and accordingly it has capitalized the same under brand development expenses and intends to amortize the same over the period in which it expects the benefits to flow. As the statutory auditor of the company do you concur? Give reasons.

**Answer**

As per AS-26 on “Intangible Assets”, expenditure on an intangible item should be recognised as an expense when it is incurred unless it forms part of the cost of an intangible asset that meets the recognition criteria.
In the given case, it incurred substantial amounts on external trade, business communication and branding expenses by participation in various corporate social responsibility initiatives. The company expects to benefit by this expenditure by attracting new customers over a period of time and accordingly it has capitalized the same under brand development expenses. Here, no intangible assets or other asset is acquired or created that can be recognized.

Therefore, the accounting treatment by the company to amortize the entire expenditure over the period in which it expects the benefits to flow is not correct and the same should be debited to the Statement of Profit and Loss in the year of incurring.

**Question 4**

(a) The Balance Sheet of G Ltd. as at 31st March 16 is as under. Comment on the presentation in terms of Schedule III.

<table>
<thead>
<tr>
<th>Heading</th>
<th>Note No.</th>
<th>31st March, 16</th>
<th>31st March, 15</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Equity &amp; Liabilities</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Share Capital</td>
<td>1</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>Reserves &amp; Surplus</td>
<td>2</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Employee stock option outstanding</td>
<td>3</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>Share application money refundable</td>
<td>4</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td><strong>Non-Current Liabilities</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deferred tax liability (Arising from Indian Income Tax)</td>
<td>5</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td><strong>Current Liabilities</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Trade Payables</td>
<td>6</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Non-Current Assets</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fixed Assets-Tangible</td>
<td>7</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>CWIP (including capital advances)</td>
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<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td><strong>Current Assets</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Trade Receivables</td>
<td>9</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>Deferred Tax Asset (Arising from Indian Income Tax)</td>
<td>10</td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td>Debit balance of Statement of Profit and Loss</td>
<td></td>
<td>XXX</td>
<td>XXX</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td>XXX</td>
<td>XXX</td>
</tr>
</tbody>
</table>
6.4 Advanced Auditing and Professional Ethics

(b) Z Ltd changed its employee remuneration policy from 1st of April 2015 to S provide for 12% contribution to provident fund on leave encashment also. As per the leave encashment policy the employees can either utilize or encash it. As at 31st March 16 the company obtained an actuarial valuation for leave encashment liability. However, it did not provide for 12% PF contribution on it. The auditor of the company wants it to be provided but the management replied that as and when the employees availed leave encashment, the provident fund contribution was made. The company further contends that this is the correct treatment as it is not sure whether the employees will avail leave encashment or utilize it. Comment.

(c) K Ltd. had 5 subsidiaries as at 31st March 2016 and the investments in subsidiaries are considered as long term and valued at cost. Two of the subsidiaries net worth eroded as at 31st March 16 and the prospects of their recovery are very bleak and the other three subsidiaries are doing exceptionally well. The company did not provide for the decline in the value of investments in two subsidiaries because the overall investment portfolio in subsidiaries did not suffer any decline' as the other three subsidiaries are doing exceptionally well. Comment.

Answer

(a) Following Errors are noticed in presentation as per Schedule III:

(i) Share Capital & Reserve & Surplus are to be reflected under the heading “Shareholders’ funds”, which is not shown while preparing the balance sheet. Although it is a part of Equity and Liabilities yet it must be shown under head “shareholders’ funds”. The heading “Shareholders’ funds” is missing in the balance sheet given in the question.

(ii) Reserve & Surplus is showing zero balance, which is not correct in the given case. Debit balance of statement of Profit & Loss should be shown as a negative figure under the head ‘Surplus’. The balance of ‘Reserves and Surplus’, after adjusting negative balance of surplus shall be shown under the head ‘Reserves and Surplus’ even if the resulting figure is in the negative.

(iii) Schedule III requires that Employee Stock Option outstanding should be disclosed under the heading “Reserves and Surplus”

(iv) Share application money refundable shall be shown under the sub-heading “Other Current Liabilities”. As this is refundable and not pending for allotment, hence it is not a part of equity.

(v) Deferred Tax Liability has been correctly shown under Non-Current Liabilities. But Deferred tax assets and deferred tax liabilities, both, cannot be shown in balance sheet because only the net balance of Deferred Tax Liability or Asset is to be shown.

(vi) Under the main heading of Non-Current Assets, Fixed Assets are further classified as under:

(a) Tangible assets
(b) Intangible assets
(c) Capital work in Progress
(d) Intangible assets under development.

Keeping in view the above, the CWIP shall be shown under Fixed Assets as Capital Work in Progress. The amount of Capital advances included in CWIP shall be disclosed under the sub-heading “Long term loans and advances” under the heading Non-Current Assets.

(e) Deferred Tax Asset shall be shown under Non-Current Asset. It should be the net balance of Deferred Tax Asset after adjusting the balance of deferred tax liability.

(b) As per Para 11 of AS-15 on “Employee Benefits”, issued by the Institute of Chartered Accountants of India, an enterprise should recognize the expected cost of short-term employee benefits in the form of compensated absences in the case of accumulating compensated absences, when the employees render service that increases their entitlement to future compensated absences.

Since the company obtained actuarial valuation for leave encashment, it is obvious that the compensated absences are accumulating in nature. An enterprise should measure the expected cost of accumulating compensated absences as the additional amount that the enterprise expects to pay as a result of the unused entitlement that has accumulated at the balance sheet date.

Here, Z Ltd will accumulate the amount of leave encashment benefits as it is the liability of the company to provide 12% PF on amount of leave encashment. Hence the contention of the auditor is correct that full provision should be provided by the company.

(c) As per AS-13 “Accounting for Investments” issued by the Institute of Chartered Accountants of India, long-term investments are usually of individual importance to the investing enterprise. The carrying amount of long-term investments is therefore determined on an individual investment basis. Investments classified as long term investments should be carried in the financial statements at cost. However, provision for diminution shall be made to recognize a decline, other than temporary, in the value of the investments, such reduction being determined and made for each investment individually.

Keeping in view the above, K Ltd should provide for the decline in the value of investments in two subsidiaries despite the fact that the overall investment portfolio in subsidiaries did not suffer any decline.

Question 5

As a statutory auditor of a company, comment on the accounting policy on Revenue Recognition for a company engaged in manufacture and sale of chemical products was stated as "Revenue is recognized only when it can be reliably measured and it is reasonable to expect ultimate collection".
Answer

Revenue Recognition: As per AS 9 Revenue Recognition, in a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions have been fulfilled:

(i) the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and

(ii) no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods.

Therefore, revenue from sales transactions should be recognised when the requirements as to performance set out above is satisfied, provided that at the time of performance it is not unreasonable to expect ultimate collection. If at the time of raising of any claim uncertainty regarding collection exist, then revenue recognition should be postponed.

In the instant case, the company is engaged in manufacturing and sale of chemical products, and made disclosure in accounting policy on recognition of revenue as per AS 1 stating that revenue is recognized only when it can be reliably measured and it is reasonable to expect ultimate collection, is correct. However, accounting policy disclosed above should also cover the aspect of transfer of risk and reward for the purpose of revenue recognition.

Question 6

M/s. PQR has been appointed the sole statutory auditor of a large company for 2015-16, where till last year M/s. LMN was also one of the joint auditors along with M/s. PQR. Mention the steps that should be taken by M/s. PQR before commencing the audit.

Answer

Steps before Commencing the Audit Work: When one of the joint auditors of the previous year 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. The provisions of section 140 of the Companies Act, 2013 (hereinafter referred as the Act) relating to non-reappointment of the retiring auditor need to be considered. As per sub-section 4 of section 140 of the Act, 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 Act.

The following steps should be taken care of by M/s. PQR before commencing the audit:

(i) Ascertain that special notice under Section 140(4) of the Act was duly 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 Act read with the Companies (Management and Administration) Rules, 2014.

(ii) 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 Act.

(iii) 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.

(iv) Verify that the said notice is also sent to the retiring auditor as per Section 140(4)(ii) of the Act.

(v) Verify whether any representation received from the retiring auditor was sent to the members of the company to whom notice of the meeting was sent as per Section 140(4)(iii) of the Act.

(vi) Verify from the minutes book whether the representation received from the retiring joint auditor was considered at the AGM.

(vii) Examine that proposed resolution was properly passed.

Further, Clause (8) of Part I of the First Schedule to the Chartered Accountants Act, 1949, provides that a member in practice shall be deemed to be guilty of professional misconduct if he accepts a position as auditor previously held by another chartered accountant without first communicating with him in writing. Moreover, Clause (9) of Part I of the same Schedule, provides that a member in practice shall be deemed to be guilty of professional misconduct if he accepts an appointment as auditor of a company without first ascertaining from it whether the requirements of Sections 224 and 225 of the Companies Act, 1956 (now Section 139 and 140 read with section 141 of the Companies Act, 2013), in respect of such appointment have been duly complied with.

Therefore, M/s PQR is required to comply with all the above mentioned provisions provided under Companies Act and Chartered Accountant Act before commencing the audit.

Question 7

A Ltd. is a manufacturer of readymade garments. It sells its products to franchisees located across the country. Readymade garment industry is subject to change in trends of fashion and as such, some of the goods are returned and A Ltd. accepts them back as sales returns. On the basis of past trends such returns are estimated to be at 20% of the sales of any year. For the financial year 2015-16, A Ltd. had accounted for the actual sales return made upto 31st March 2015 but has not reversed the possible expected return that are likely to happen after 31st March 2016, in respect of the sale made for the FY 15-16. Mr. X the auditor of A Ltd. wants this to be considered in the accounts for the year ended on 31st March 2016 but the company is of the opinion that although there is a probability of some goods being returned by the franchisees, there is no significant uncertainty regarding the amount of consideration that will be derived from the sale of goods, since the goods are not in the possession of the company and risk and rewards of ownership still lie with the franchisees and the company cannot record
sales returns in its books of account in respect of goods that are likely to be received after the date of balance sheet. Comment.

Answer

Recognition of Revenue: AS 9 on 'Revenue Recognition', states that revenue from sale of goods should be recognised when the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership and no significant uncertainty exists regarding the amount of consideration.

Further, revenue recognition is mainly concerned with the timing of recognition of revenue in statement of profit and loss of an enterprise. The amount of revenue arising on a transaction is usually determined by the agreement between the parties involved in the transaction. When uncertainties exist regarding the determination of the amount, or its associated costs, these uncertainties may influence the timing of revenue recognition.

In the present case, A Ltd. is a manufacturer of readymade garments and sells its products to franchisees located across the country. Due to change in trends of fashion etc sold goods are being returned and A Ltd. accepts them back as sales returns. On the basis of past trends such returns are estimated as 20% of the sales of any year.

In this case, the company is bearing the risk of sales return and therefore, the company should not recognize the revenue to the extent of 20% of its sales. The company may disclose suitable revenue recognition policy in its financial statements separately.

In the absence of the above, the auditor must qualify his report.

Note: Alternative Answer is possible on the basis of AS 29 on Provisions, Contingent Liabilities and Contingent Assets by recognizing the whole sales as revenue, i.e., 100% accounted in Statement of Profit and Loss as sales Income as there is no significant uncertainty regarding the amount of consideration. However, keeping in view its past performance, A Ltd. should make a provision for sales income which is not likely to realise. In the absence of the above, the auditor will have to qualify his report.

Question 8

Comment on the following:

(a) MRE Ltd. provided ₹25 lakhs for Inventory obsolescence in 2015-16. In the subsequent years, it was determined that 50% of such inventory was usable. The Board of Directors wants to adjust the same through prior period adjustment.

(b) ABC & Co. and DEF & Co, Chartered Accountant firms were appointed as joint auditors of Good Health Care Ltd. for 2015-16. A special audit was conducted during March 2016 and observed gross understatement of Revenue. The revenue aspects were looked after by DEF & Co, but there was no documentation for the division of work between the joint auditors.
Answer

(a) **Prior Period Adjustment:** As per AS 5 on "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies", prior period items are income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods. The write-back of provision made in respect of inventories in the earlier year does not constitute prior period adjustment since it neither constitutes error nor omission but it merely involves making estimates based on prevailing circumstances when financial statements were being prepared. It is a mere estimate process involving judgement based on the latest information available.

An estimate may have to be revised if changes occur regarding the circumstances on which the estimate was based, or as a result of new information, more experience or subsequent developments. The revision of the estimate, by its nature, does not bring the adjustment within the definitions of an extraordinary item or a prior period item.

A change in an accounting estimate may affect the current period only or both the current period and future periods. In both cases, the effect of the change relating to the current period is recognised as income or expense in the current period. The effect, if any, on future periods, is recognised in future periods.

Further, as per SA 540 “Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures”, the auditor shall review the outcome of accounting estimates included in the prior period financial statements or where applicable, their subsequent re-estimation for the purpose of the current period.

In this case, MRE Ltd. provided ₹ 25 lakhs for inventory obsolescence in 2015-16. In the subsequent year due to change in circumstances, it was determined that 50% of such inventory was usable. Revision of such an estimate does not bring the resulting amount of ₹ 12.5 lakhs within the definition either of a prior period item or of an extraordinary item. The amount, however, involved is material and requires separate disclosure to understand the financial position and performance of an enterprise. Accordingly, adjustment in the value of the inventory through prior period item would not be proper.

(b) **Documentation for Division of Work between the Joint Auditors:** As per SA 299 “Responsibility of Joint Auditors”, where joint auditors are appointed, they should, by mutual discussion, divide the audit work among themselves. The division of work would usually be in terms of audit of identifiable units or specified areas.

In some cases, due to the nature of the business of the entity under audit, such a division of work may not be possible. In such situations, the division of work may be with reference to items of assets or liabilities or income or expenditure or with reference to periods of time. Certain areas of work, owing to their importance or owing to the nature of the work involved, would not be divided and would be covered by all the joint auditors.

The division of work among joint auditors as well as the areas of work to be covered by all of them should be adequately documented and preferably communicated to the entity.
Further, each joint auditor is entitled to assume that the other joint auditors have carried out their part of the audit work in accordance with the generally accepted audit procedures. It is not necessary for a joint auditor to review the work performed by other joint auditors or perform any tests in order to ascertain whether the work has actually been performed in such a manner. Each joint auditor is entitled to rely upon the other joint auditors for bringing to his notice any departure from generally accepted accounting principles or any material error noticed in the course of the audit.

In the present case, there was no documentation for the division of work and the responsibility of revenue aspect was delegated to DEF & Co., in which gross understatement of revenue has been observed. ABC & Co. has not reviewed the work as they have put their reliance on the work performed by DEF & Co. Hence, there is a violation of SA 299 as the division of work has not been documented. In the normal course DEF & Co. will be held liable for negligence. If DEF & Co. refuses to accept sole responsibility for the fault, ABC & Co. have to prove by other ways and means of evidences that the particular area of audit was exclusively done by DEF & Co. only.

Question 9
A infrastructure company has constructed a mall and entered into agreement with tenants towards license fees (monthly rental) and variable license fees, a percentage on the turnover of the tenant (on an annual basis). Chief Finance Officer wants to account/recognize license fee as income for 12 months during current year under audit and variable license fees as income during next year, since invoice is raised in the subsequent year. As an auditor, how would you deal and state in the statement of Accounting policies?

Answer
Revenue Recognition: AS 9 on Revenue Recognition, is mainly concerned with the timing of recognition of revenue in the statement of profit and loss of an enterprise. The amount of revenue arising on a transaction is usually determined by agreement between the parties involved in the transaction. However, when uncertainties exist regarding the determination of the amount, or its associated costs, these uncertainties may influence the timing of revenue recognition.

Further, as per accrual concept of fundamental accounting assumptions given in AS 1 “Disclosure of Accounting Policies”, revenue should be recognised as and when it is accrued i.e. recorded in the financial statements of the periods to which they relate.

In the present case, monthly rental towards licence fees and variable licence fees as a percentage on the turnover of the tenant though on annual basis is the income related to common financial year. Therefore, recognising the fees as revenue cannot be deferred simply because the invoice is raised in subsequent period. Hence it should be recognised in the financial year of accrual.

Therefore, the contention of the Chief Financial Officer is not in accordance with AS 9 and hence the auditor may qualify the report indicating the understatement of income/profit and that the Statement of Profit and Loss does not exhibit a true and fair view of the profit or loss.
Question 10

(a) In the course of audit of T Ltd. you observed that export incentives are not accounted on accrual basis. The company’s management contended that these would be accounted on cash basis citing the uncertainty about its receipts as they are not admitted as due by the customs authorities. Comment.

(b) Z Ltd. has flexi deposit linked current account with various banks. Cheques are issued from the current account and as per the requirements of funds, the flexi deposits are encashed and transferred to current accounts. As of 31st March, 2016 certain cheques issued to vendors are not presented for payment resulting in the credit balance in the books of the company. The management wants to present the book overdraft under current liabilities and flexi deposits under cash & bank balances. Comment.

Answer

(a) Accountability of Export Incentives: The exporters receive certain incentives (monetary or non-monetary) from the Government of India on export of goods. However due to various procedural delays and laws involved which keep changing frequently, there is generally a delay in actual receipt of the export incentives. Further the receipt of the export incentives may not be assured in certain situations due to frequent changes in the policies of the Government. In such cases, it may be reasonable to presume that the receipt of the incentives is uncertain till the time they are actually received.

As per AS 9 “Revenue Recognition”, if at the time of raising the claim for incentive, it is unreasonable to expect ultimate collection, revenue recognition should be postponed. Therefore, as per the accounting standard, if there is uncertainty in the receipt of the amounts, then the revenue in respect of such incentives ought not to be recognized in the books of accounts.

Therefore, revenue is to be recognized only when there is reasonable certainty in the receipt of the same. Hence contention of management of T Ltd. to record the export incentive on cash basis is correct.

Note: An Alternative view is possible, since the export incentives are due as and when the exports have been made from India, though customs authorities does not acknowledge them as due. This does not mean that an uncertainty arises about its receipt. If at all customs authorities have an objection it should be at the time of clearance of the goods for export. The only uncertainty is the timing of the receipt of such incentives, but not the incentive itself. Hence T Ltd. has to account the export incentives on Accrual basis.

(b) Presentation of Book Overdraft as per Schedule III to the Companies Act, 2013: The instructions in accordance with which current assets being “cash and cash equivalents” should be made out to Part I of Schedule III to the Companies Act, 2013 states as follows:

(i) Cash and cash equivalents shall be classified as:

(a) Balances with banks;

(b) Cheques, drafts on hand;
(c) Cash on hand;
(d) Others (specify nature).

(ii) Earmarked balances with banks (for example, for unpaid dividend) shall be separately stated.

(iii) Balances with banks to the extent held as margin money or security against the borrowings, guarantees, other commitments shall be disclosed separately.

(iv) Repatriation restrictions, if any, in respect of cash and bank balances shall be separately stated.

(v) Bank deposits with more than 12 months maturity shall be disclosed separately.

From the facts of the case it is evident that in substance the position is that the composite bank balance including the balance in flexi deposit accounts are positive, even though physical set-off has not been made as on the balance sheet date. Further the bank has got the right to set off of flexi deposits against the cheques issued and hence it would be more informative and useful to the readers of the financial statements to disclose the book credit balance as a set-off from the flexi deposit accounts. The disclosure of the said book credit balance as book overdraft under the head current liabilities as proposed by the management is not correct.

Question 11

Comment on the following:

(a) B Co. Ltd. is engaged in the business of developing mass scale housing projects including development of small commercial complexes. The flats/commercial spaces are booked by the public and are allotted by way of allotments letter to each allottee. Major construction activities pertaining to buildings are undertaken after allotment is over. After completing the construction, possession of flats/commercial spaces is given to allottees by executing legal document. The CEO of the B Co. Ltd. says that AS 7 is not applicable to the company.

(b) During the course of audit of D Co. Ltd. you as an auditor have observed that Inter Corporate deposit of ₹ 50 lakhs has been overdue. The D Co. Ltd. have disclosed this in the notes to accounts note No. 15 in schedule no. 21 stating that ₹ 50 lakhs is overdue from XYZ Co. Ltd. and the said company is in the process of liquidation. The management is taking steps to appoint the liquidator.

Answer

(a) Applicability of AS 7: The contention of the CEO of B Co. Ltd. is correct. AS 7 “Construction Contract”, should be applied in accounting for construction contracts in the financial statements of contractors.

The activity of the B Co. Ltd. is not that of a contractor. The company is developing projects on its own account as a commercial venture and is in the nature of production activity and not that of a contractor. Therefore, AS 7 will not be applicable to B Co. Ltd.
For the purpose of recognition of Revenue and valuation of inventories, B Co. Ltd. should follow the principles contained in AS 9 “Revenue recognition” and AS 2 “Valuation of Inventories”.

(b) As per AS 4 “Contingencies and Events occurring after the Balance Sheet Date”, adjustments to assets and liabilities are required for events occurring after the balance sheet date that provide additional information materially affecting the determination of the amounts relating to conditions existing at the balance sheet date.

In the instant case, it appears from the note no. 15 that the overdue of outstanding inter corporate deposit may not be realisable in full. The company is in the process of liquidation, makes it clear that on the balance sheet date, the amount of deposit is not safe and is not likely to be realised.

Therefore, as per AS 4 provision for the loss is required in the accounts. Hence the auditor should qualify the Audit Report.

Question 12

Mr. Ram, a relative of a Director was appointed as an auditor of the company. Comment.

Answer

Appointment of the Auditor: Section 141 of the Companies Act 2013 (herein after referred as the Act) deals with the eligibility, qualifications and disqualifications of Auditors. Sub-section (3)(f) of the Section 141 of the Act, explicitly disqualifies a person from being appointed as an auditor of a company whose relative is a director or is in the employment of the company as a director or key managerial personnel.

Further, as per Council Guidelines, 2008 a member of the institute shall desist from expressing his opinion on financial statements of any business or enterprise in which one or more persons, who are his relatives within the meaning of AS-18, have either by themselves or in conjunction with such member, a substantial interest in the said business or enterprise. Therefore, if the director has substantial interest in the company then his relative should not accept the appointment of auditor of that company.

In the instant case, Mr. Ram is the relative of a Director of the company, therefore, he should not accept the appointment as an auditor of that company. If he accepts such appointment, he would be guilty of professional misconduct and would also be liable for punishment for contravention of the provisions of the Companies Act.

Question 13

While doing the audit, X, the Statutory Auditor of ABC Ltd. observes that certain loans and advances were made without proper securities, certain trade receivables and trade payables were adjusted inter se, and personal expenses were charged to revenue. Comment.

Answer

Audit Report: Section 143(1) of the Companies Act, 2013 requires the auditor to make an enquiry in respect of specified matters during the course of his audit. Since the law requires the
auditor to make an enquiry, the Institute opined that the auditor is not required to report on the matters specified in sub-section (1) unless he has any special comments to make on any of the items referred to therein. If the auditor is satisfied as a result of the enquiries, he has no further duty to report that he is so satisfied. It is to be noted that the auditor is required to make only enquiries and not investigate into the matters referred to therein.

Clause (a) of Section 143(1) requires the auditor to inquire: “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”.

If the auditor finds that the loans and advances have not been properly secured, he may enter an adverse comment in the report but cannot probably doubt the true view of the accounts by reference to this fact so long the loans and advances are properly described and presented in terms of Part I of Schedule III to the Companies Act. Further the auditor to inquire whether or not the terms on which the loans or advances have been made are prejudicial to the interests of the company or its members. If it is, he should qualify his report.

If trade receivables and trade payables are adjusted inter se, this amounts to merely book entries. The auditor, as per clause (b) of section 143(1), should enquire “whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company”. This proposition has got to be inquired into by reference to the effects of the book entries, unsupported by transactions, on the legitimate interests of the company. The auditor has to exercise his judgment based on certain objective standards”.

Regarding Personal Expenses, Clause (e) of section 143(1) requires the auditor to inquire: “Whether personal expenses have been charged to revenue account”. The charging to revenue of such personal expenses, either on the basis of the company’s contractual obligations, or in accordance with accepted business practice, is perfectly normal and legitimate or does not call for any special comment by the auditor. Where, however, personal expenses not covered by contractual obligations or by accepted business practice are incurred by the company and charged to revenue account, it would be the duty of the auditor to report thereon. It suffices to say that if the auditor finds that personal expenses have been charged to revenue and if the amounts are material, he should qualify his report also.

In the instant case, Mr. X, the statutory auditor of ABC Ltd., needs to enquire in light of above provisions, as a result of the enquiries if he is satisfied then there is no further duty to report on these matters.

**Question 14**

*T Ltd., an Indian company, subject to Indian Income Tax Act, 1961, discloses advance Income-tax paid (Current tax asset) and provision for Income-tax (Current tax liability), separately in Balance Sheet for the year ended 31.3.2016, i.e., it does not offset the amount. Comment.*

**Answer**

**Offsetting Assets and Liabilities:** As per paragraph 27 of Accounting Standard (AS) 22—“Accounting for Taxes on Income”, an enterprise should offset assets and liabilities representing current tax if the enterprise:
(i) has a legally enforceable right to set off the recognized amounts and
(ii) intends to settle the asset and liability on a net basis.

An enterprise will normally have a legally enforceable right to set off an asset and liability representing current tax when they relate to income taxes levied under the same governing taxation laws and the taxation laws permit the enterprise to make or receive a single net payment.

Since T Ltd. is an Indian Company, and as per Income Tax Act, 1961, such set off is allowed which is legally enforceable. Thus, in view of Provisions of AS 22 and Income Tax Laws, T Ltd. should offset advance tax paid against provision for income tax and show only the net amount in the balance sheet.

Question 15

Dark Ltd. has received a grant of ₹ 20 lacs under the Government’s Subsidy Scheme for acquiring an imported machinery for setting up an oil exploration plant and the entire grant received is credited to Statement of Profit and Loss.

Answer

Accounting for Government Grants: According to AS 12, “Accounting for Government Grants”, where grant is received for the acquisition of a specific fixed asset, the same cannot be credited to Statement of Profit and Loss since it fails to match revenue with the cost.

As per AS 12, such grants should be presented in the balance sheet showing the grant as a deduction from the gross value of the asset concerned (in arriving at its book value). Alternately, the grants related to a depreciable fixed asset may be treated as deferred income which should be recognised in the Statement of Profit and Loss on a systematic and rational basis over the useful life of the asset. By crediting the entire amount of grant to the Statement of Profit and Loss, the company has treated it as a revenue income which is not in accordance with the requirements of the Accounting Standard.

Therefore, the statutory auditor would have to qualify appropriately that the income has been overstated to the extent of the amount of grant net of proportionate credit that would have been worked out.

Question 16

X Ltd. did not follow the applicable Accounting Standard for disclosing Earnings Per Share (EPS) in the financial statements. The fact of such non-disclosure was however, mentioned in the notes forming part of accounts. As the statutory auditor of X Ltd., how would you report in the above case?

Answer

Disclosure of EPS is required for all companies as per AS 20 “Earnings per Share”. AS 20 is also one of the AS notified by Section 133 of the Companies Act, 2013 read with the clarification given by the Ministry of Corporate Affairs (MCA) vide General Circular that the existing
Accounting Standards notified under the Companies Act, 1956 shall continue to apply till it is prescribed by Central Government.

If the disclosures required by AS 20 are not made, it is the duty of the auditor to qualify in his report "Whether Accounting Standards under the clause as notified u/s 129(1) have been followed?" Mere disclosure by company in notes does not absolve him of his duty.

The same is, however, not a qualification to affect the “True & Fair” position of financial results of the company.

**Question 17**

*X Ltd. paid ₹ 25 lakhs as advance to Y Ltd. towards the purchase of a printing machinery on 15.1.16 with delivery instructions to deliver the same in the last week of June, 16. Further on 2.2.16 X Ltd. purchased two diesel generator sets from Y Ltd. for ₹ 30 lakhs on 90 days Credit term. In the accounts for 2015-16, X Ltd. intends to adjust the advance paid against Credit purchase and show the net amount of ₹ 5 lakhs as due from them. As the statutory auditor, how would you deal with this?*

**Answer**

**Adjustment of Advances:** Since X Ltd. has paid advance amount to the supplier of machinery to be used in the project, such advance amount should be grouped under the head ‘Capital Work in Progress’. This is as per requirement of Schedule III to the Companies Act, 2013 and the existing accounting practice.

If the advance is for purchase of other machinery, it should be grouped under a separate head – say ‘Advance Payment for Capital Expenditure’ and should be disclosed as next item to Fixed Assets in the Balance Sheet.

In view of the above, the proposal of X Ltd., to show the net balance in the personal account of Y Ltd., is not correct. Such proposal will conceal the two material items in the balance sheet – one, expenditure towards capital asset and the other current liability for purchase of the generator set.

Hence, the auditor should advise X Ltd. to show these two items separately. If X Ltd. does not accept the advice, the auditor should qualify his report with suitable quantification of amount involved.

**Question 18**

*As Auditor of Act Fast Ltd. what steps will you take to ensure that the dividend has been paid only out of profit?*

**Answer**

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

1. Check whether the dividend was declared out of profits arrived at after providing for depreciation as per Section 123(2) of the Companies Act, 2013 (herein after referred as the Act).
2. Check whether-
   (i) the depreciation was provided according to provision of Schedule II to the Act.
   (ii) a board resolution recommending dividend was passed.
   (iii) the dividend was declared only in the Annual General Meeting.
   (iv) no dividend declared in general meeting exceeds the amount recommended by the Board.
   (v) amount paid or credited as paid on a share in advance of calls is not treated for the purpose of this regulation as paid on the share.
   (vi) register of members was closed as per the provisions of section 91 of the Act.
   (vii) dividend has been paid in the prescribed manner within 30 days of time to the registered holder or their order for the compliance of Section 127 of the Act.
   (viii) Amount of dividend deposited in a separate bank account within five days from the date of declaration of dividend.
   (ix) intimation sent to Stock Exchange in the case of listed company.
   (x) were there any complaints of non-payment/delayed payment of dividend? If so, whether corrective action was taken.

Question 19
As a Statutory Auditor, how would you deal with the following:

(a) While adopting the accounts for the year, the Board of Directors of Sunrise Ltd. decided to consider the Interim Dividend declared @15% as final dividend and did not consider transfer of Profit to reserves.

(b) V Ltd. sold 1 lakh vacuum pumps during the year 2015-16 with a condition to make good by repair/replacement any manufacturing defects reported within 6 months from the date of sale. Past experience in this regard showed that there were no replacements carried out, but minor/major repairs were necessitated to the extent of 10%/5% respectively of the units sold. The cost of such minor/major repairs would amount to ₹1,000/₹6,000 respectively. While finalizing the accounts for the year, the company does not reflect any provision, in this regard.

Answer

(a) Declaration of Interim Dividend: Section 123(3) of the Companies Act, 2013 provides that the Board of Directors of a company may declare interim dividend during any financial year out of the surplus in the Statement of Profit and Loss and out of profits of the financial year in which such interim dividend is sought to be declared. The amount of dividend including interim dividend should be deposited in a separate bank account within five days from the declaration of such dividend for the compliance of Section 123(4) of the said Act.

Based on Section 2(35) of the said Act, it can be said that since interim dividend is also a dividend, companies should provide for depreciation as required by Section 123 before
declaration of interim dividend. However, the first proviso to Section 123(1) provides that a company may, before the declaration of any dividend in any financial year, transfer such percentage of its profit for that financial year as it may consider appropriate to the reserves of the company irrespective of the size of the declared dividend i.e. the company is not mandatorily required to transfer the profit to the reserves, it is an option available to the company to transfer such percentage.

In the instant case, the Board has decided to pay interim dividend @15% of the paid-up capital. Assuming that the company has complied with the depreciation requirement, the interim dividend can be declared without transferring such percentage of its profits as it may consider appropriate to the reserves of the company.

(b) **Provisions:** As per AS – 29, ‘Provisions, Contingent Liabilities and Contingent Assets’, a provision is a liability which can be measured only by using a substantial degree of estimation.

As per AS – 29, a provision should be recognised when:

(i) An enterprise has a present obligation as a result of a past event;

(ii) It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

(iii) A reliable estimate can be made of the amount of the obligation.

If these conditions are not met, no provision should be recognised.

In the present case, V Ltd. fulfils all the above conditions. The sale of pumps with a warranty obligation constitutes the present obligation as a result of past event. It is probable that some outflow will be involved in settling the warranty obligation, satisfy the second condition. As per the details based on past precedence reliable estimate can be made as under:

\[
[6000 \times (5\% \text{ of } 100000) + 1000 \times (10\% \text{ of } 100000)] = \text{ ₹} 400 \text{ lakhs}
\]

Thus, V Ltd. as on 31.3.2015 should make a provision for warranty obligation against sale of vacuum pumps to the extent of ₹ 400 lakhs. The auditor should insist on such provision being created. If provision is not made he should qualify his audit report.

**Question 20**

*What are the steps to be taken by a firm of Chartered Accountant to ensure that its appointment as Statutory Auditor of a Company is valid?*

**Answer**

**Validity of Appointment as a Statutory Auditor:** To ensure that the appointment is valid, the incoming auditor should take the following steps before accepting his appointment:

(i) **Ceiling limit:** Ensure that a certificate has been issued under section 139 of the Companies Act, 2013 so that the total number of company audits held by the firm (including the new appointment) will not exceed the specified number.
(ii) **Resolution at AGM**: Verify that at AGM of the Company, a proper resolution is passed. Inspect general meeting minutes book to see that the appointment is duly recorded.

(iii) **Compliance with law**: Satisfy that the legal procedure contemplated in section 139 and 140 of the said Act, dealing with the appointment and removal of existing auditor, have been followed. Also check whether section 139(5) and 139(7) (in 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- appointment by the Comptroller and Auditor General of India) are attracted and complied with.

(iv) **Code of conduct**: Communicate with the previous auditor, if any, in writing, to ascertain if there are any professional reasons for not accepting the appointment.

**Question 21**

*Write short notes on the following:*

(a) **Key Management Personnel**

(b) **Normal Capacity for the purpose of Inventory valuation**

(c) **Integral Foreign Operations**

**Answer**

(a) **Key Management Personnel**: As per AS 18 on Related Party Disclosures, “Key management personnel” are those persons who have the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise.

Further, Section 2(51) of the Companies Act, 2013 also defines the “key managerial personnel” in relation to a company as the Chief Executive Officer or the managing director or the manager; the company secretary; the whole-time director; the Chief Financial Officer; and such other officer as may be prescribed.

It may be noted here that non-executive directors of a company will not be considered as key management personnel under AS 18 by virtue of merely their being directors, unless they have the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise.

Further, the requirements of AS 18 should not be applied in respect of a non-executive director even if he participates in the financial and/or operating policy decision of the enterprise unless he falls in any of the categories discussed in Para 3 of AS 18.

(b) **Normal Capacity for Inventory Valuation**: As per AS 2 on Valuation of Inventories, allocations of fixed production overheads for the purpose of their inclusion in the costs of conversion is based on the normal capacity of the production facilities.

Normal capacity is the production expected to be achieved on an average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance. The actual level of production may be used if it approximates normal capacity. Due to this, the fixed overhead allocated to each unit of
production is not increased as a consequence of low production or idle plant. In periods of high production, these overheads allocated are decreased so that inventories are not measured above cost.

(c) Integral Foreign Operations: As per AS 11 on The Effects of Changes in Foreign Exchange Rates, there are foreign operations, the activities of which are an integral part of the reporting enterprise. This is important since the method used to translate financial results of a foreign operation depends on the way in which it is financed and operates in relation to the reporting enterprise.

A foreign operation that is integral to the operation of the reporting enterprise carries on its business as if it were an extension of the reporting enterprise’s operations. In such cases, change in exchange rates between the reporting currency and the currency in the country of foreign operation has an almost immediate effect on the reporting enterprise’s cash flow from operations. Therefore, the change in the exchange rates affects the individual monetary items held by the foreign operation rather than the net investment in that operation.

Question 22
As a Statutory Auditor, how would you deal with the following:

(a) A company capitalises interest on borrowings incurred for holding investments by adding the same to the cost of investment every year.

(b) X Ltd. is engaged in manufacture of Cement. In the Statement of Profit and Loss for the year ended 31st March, 2016, it discloses its revenue from sales transactions (turnover) net of excise duty. The excise duty collected and paid on sales transactions and that related to difference between Closing inventory and Opening inventory is, however, disclosed in the “Notes to Accounts”.

Answer

(a) Capitalisation of Interests: Investments are assets held by an enterprise for earning income by way of dividends, interest, and rentals, for capital appreciation, or for other benefits to the investing enterprise. As per AS-13 “Accounting for Investments”, cost of investments includes acquisition charges such as brokerage, fees and duties. As per AS 16 “Borrowing Costs”, borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalized as part of the cost of that asset. Other borrowing costs should be recognised as an expense in the period in which they are incurred. A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. Assets that are ready for their intended use or sale when acquired are not qualifying assets. Therefore, such investment is not a qualifying asset, therefore interest cost of holding investments cannot be capitalized.

(b) Disclosure requirement of Excise Duty: As per Accounting Standard Interpretation – ASI 14 ‘Disclosure of Revenue from Sales Transactions’ (Revised) issued by ICAI in Aug 2006, the amount of turnover should be disclosed as follows on the face of the Statement of Profit
and Loss:

- Turnover (Gross): XX
- Less: Excise duty: XX
- Turnover (Net): XX

Further, the excise duty shown above should be the total duty except the duty related to the difference between closing inventory & opening inventory which should be recognized separately in the Statement of Profit and Loss, with an explanatory note in the notes to accounts to explain the nature of the two amounts of excise duty.

Since the company, X Ltd has not followed the above ASI 14, the auditor would have to qualify his report accordingly.

**Question 23**

*Write a short note on Purchase method of Accounting for amalgamations.*

**Answer**

**Purchase Method of Accounting for Amalgamation:** As per AS 14 on Accounting for Amalgamations, there are two main methods of accounting for amalgamations i.e. the pooling of interests method and the purchase method. Under the purchase method in preparing the transferee company’s financial statements, the assets and liabilities of the transferor company should be incorporated at their existing carrying amounts or, alternatively, the consideration should be allocated to individual identifiable assets and liabilities on the basis of their fair values at the date of amalgamation. The reserves (whether capital or revenue or arising on revaluation) of the transferor company, other than the statutory reserves, should not be included in the financial statements of the transferee company. Any excess of the amount of the consideration over the value of the net assets of the transferor company acquired by the transferee company should be recognised in the transferee company’s financial statements as goodwill arising on amalgamation. If the amount of the consideration is lower than the value of the net assets acquired, the difference should be treated as Capital Reserve. The goodwill arising on amalgamation should be amortised to income on a systematic basis over its useful life. The amortization period should not exceed five years unless a somewhat longer period can be justified. Where the requirements of the relevant statute for recording the statutory reserves in the books of the transferee company are complied with, statutory reserves of the transferor company should be recorded in the financial statements of the transferee company. The corresponding debit should be given to a suitable account head (e.g., ‘Amalgamation Adjustment Account’) which should be disclosed as a part of ‘miscellaneous expenditure’ or other similar category in the balance sheet. When the identity of the statutory reserves is no longer required to be maintained, both the reserves and the aforesaid account should be reversed.

**Question 24**

*In the audit of ABC Private Limited, auditor came across cases of payments to Directors, whereby, expenses of a personal nature were re-imbursted. As an auditor, how would you deal with the same?*
Answer

Reimbursement of Personal Expenses of Director: All payments to Directors as remuneration or perquisites whether in the case of a public or private company are required to be authorised both in accordance with the Companies Act and Articles of Association of the company. Articles may provide that such remuneration require sanction of the shareholders either by ordinary or special resolution while in some cases it may require only approval of Directors. If the terms of appointment of a Director include payment of expenses of a personal nature, then such expenses can be incurred by the company; otherwise, no such expense can be incurred or reimbursed by the company. In the instant case the auditor has to ensure that the above is complied with, without which, if such expenses are paid, he has to disclose the fact in his report, as also in the accounts. In this regard attention is invited to section 143(1)(e) of the Companies Act, 2013 wherein auditor has to inquire into whether personal expenses have been charged to revenue.

Question 25

Apex Ltd., a well reputed manufacturing public limited company has made a contribution of ₹ 2.5 lacs during the financial year ended 31.3.16 to a political party for running a school, situated in the village, where most of the workers of the company reside. It is admitted that the benefit of the school is mostly for the children of the workers of the company. The company has not made any profits in the last four years.

Answer

Restrictions Regarding Political Contribution: Section 182 of the Companies Act, 2013 deals with prohibitions and restrictions regarding political contributions. According to this section, a government company or any other company which has been in existence for less than three financial years cannot contribute any amount directly or indirectly to any political party. In other cases, contribution in any financial year should not exceed 7½ % of average net profits during the three immediately preceding financial years. The company in question has not made any profit in last four years and contributed ₹ 2.5 lacs during the year to a political party for running a school. This is violation of the provisions of Section 182 of the said Act although the children of its workers are benefited. The auditor would have to qualify his report stating the contravention of the provisions of the Companies Act.

Question 26

Write a short note on Effect of uncertainties on revenue recognition.

Answer

Effect of Uncertainties on Revenue Recognition: Para 9 of AS 9 “Revenue Recognition” deals with the effect of uncertainties on revenue recognition. The Para states-

(i) Recognition of revenue requires that revenue is measurable and at the time of sale or the rendering of the service it would not be unreasonable to expect ultimate collection.

(ii) Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, e.g. for escalation of price, export incentives, interest etc.,
revenue recognition is postponed to the extent of uncertainty involved. In such cases it may be appropriate to recognize revenue only when it is reasonably certain that the ultimate collection will be made. When there is no uncertainty as to ultimate collection, revenue is recognized at the time of sale or rendering of service even though payments are made by instalments.

(iii) When the uncertainty relating to collectability arises subsequent to the time of sale or rendering of the service, it is more appropriate to make a separate provision to reflect the uncertainty rather than to adjust the amount of revenue originally recorded.

(iv) An essential criterion for the recognition of revenue is that the consideration receivable for the sale of goods, the rendering of services or from the use by others of enterprise resources is reasonably determinable. When such consideration is not determinable within reasonable limits, the recognition of revenue is postponed.

(v) When recognition of revenue is postponed due to effect of uncertainties, it is considered as revenue of the period in which it is properly recognised.

Question 27

As a statutory auditor, how would you deal with the following:

(a) A Pvt. Ltd., started stock broking activities in 2016. For this purpose it acquired membership of a stock exchange for ₹110 lacs. While finalizing the accounts, the company disclosed the above amount under the Fixed Assets schedule as “Stock Exchange Membership Rights”. The company also did not write off any amount since the rights would enable the company to perpetually carry on its business.

(b) XYZ Ltd. had received a grant of ₹50 lacs in 2008 from a State Government towards installation of pollution control machinery on fulfilment of certain conditions. The company, however, failed to comply with the said conditions and consequently was required to refund the said amount in 2016.

The company debited the said amount to its machinery in 2016 on payment of the same. It also reworked the depreciation for the said machinery from the date of its purchase and passed necessary adjusting entries in the year 2016 to incorporate the retrospective impact of the same.

Answer

(a) Stock Exchange Membership Rights: A Pvt. Ltd. has paid ₹110 lacs for acquiring membership of stock exchange. Such membership rights provide exclusive right to A Pvt. Ltd. for carrying out stock broking activities. Thus, Stock Exchange Membership Rights are controlled by A Pvt. Ltd. and provide the basis for generating economic benefits to it. All these criteria appear to meet the definition of intangible assets as laid down in AS 26, “Intangible Assets”. The Standard requires an entity to recognize an intangible asset if it is probable that the future economic benefits that are attributable to the asset will flow to the enterprise and the cost of the asset can be measured reliably. In the instant case, membership rights of stock exchange acquired by A Pvt. Ltd. meet the criteria of
identifiability, control and arising of future benefits as well as reliability of the amount of cost. Thus recognizing the membership rights as Fixed Assets is proper.

However, the fact that the company did not write-off any amount since it would enable the company to perpetually carry on its business is not proper since AS 26 requires that all Intangible Assets to be amortised. For this purpose, a rebuttable presumption of 10 years is to be considered. Hence in the instant case, the company should have amortised such rights over 10 years. Since the company has not amortised any amount, the auditor will have to qualify his report and state the fact of non-compliance with AS 26.

(b) **Refund of Government Grant:** As per facts of the case, XYZ Ltd. had received a grant of ₹ 50 lacs in 2008 from a State Government towards installation of pollution control machinery on fulfilment of certain conditions. However, the amount of grant has to be refunded since it failed to comply with the prescribed conditions. In such circumstances, AS 12, “Accounting for Government Grants”, requires that the amount refundable in respect of a government grant related to a specific fixed asset is recorded by increasing the book value of the asset or by reducing the capital reserve or the deferred income balance, as appropriate, by the amount refundable. The Standard further makes it clear that in the first alternative, i.e., where the book value of the asset is increased, depreciation on the revised book value should be provided prospectively over the residual useful life of the asset. Accordingly, the accounting treatment given by XYZ Ltd. of increasing the value of the plant and machinery is quite proper. However, the accounting treatment in respect of depreciation given by the company of adjustment of depreciation with retrospective effect is improper and constitutes violation of relevant Accounting Standards.

The auditor, therefore, should discuss with the management to make necessary changes in respect of same and if not agreed to, qualify the report quantifying the impact of the same on profit as well as assets of the company.

**Question 28**

*Write a short note deferred taxation.*

**Answer**

**Deferred Taxation:** AS 22 “Accounting for Taxes on Income”, prescribes the accounting treatment for taxes on income. The amount of taxable income for a period and the amount of profit (or loss) as shown by the Statement of Profit and Loss for that period are seldom the same. The difference between accounting income and taxable income arise due to the fact that taxable income is calculated in accordance with tax laws whose requirements regarding computation of taxable income differ from the accounting policies applied to determine accounting income. The difference between taxable income and accounting income can be classified into ‘permanent differences’ and ‘timing differences’. ‘Permanent differences’ are the differences between taxable income and accounting income for a period that originate in one period and do not reverse subsequently. Timing differences, on the other hand, are those differences between taxable income and accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods. The standard requires that deferred tax should be recognized for all timing differences, subject to the consideration of
prudence in respect of deferred tax assets. Deferred tax represents the future tax effects of timing differences. Some timing differences are such that their reversal in future year(s) would result in the taxable income for the year(s) of reversal being higher than the accounting income for that year (or those years).

Question 29

As a Statutory Auditor, how would you deal with the following:

(a) ABC Ltd. commenced construction of a flyover in Mumbai in January, 2015 under BOLT scheme. The same was completed in February, 2016. Due to seasonal heavy rains in July, 2015 in the area, the work on the flyover had to be suspended for 1 month. The company accordingly suspended borrowing costs of ₹12.50 lakhs for that month from capitalization.

(b) P Ltd. of whom you are the Statutory Auditor appoints M/s XYZ as Branch Auditors for one of its branches. M/s XYZ conducted the audit of the branch without visiting the branch and instead getting the books at the H.O. M/s XYZ has submitted their Branch Audit Report to you.

(c) LM Ltd. has 2 divisions L and M. The finished products of division L are transferred to division M where further processing is carried out before sale to customers. To achieve transparency and accountability between the divisions, division L raises an invoice on division M at cost plus normal margins. At the year end the unrealized profits on inter-division inventories are eliminated. However, the transfers are recorded at the invoice value as sales and purchases in the respective divisions for the purpose of preparing the Statement of Profit and Loss. Suitable disclosures, for this are given in then ‘Notes to Accounts’.

(d) T Pvt. Ltd. is an unlisted closely held company with turnover less than ₹50 crores. While finalizing the accounts, Mr. M the Director (finance) disputed the applicability of AS 20 to the company.

Answer

(a) Capitalisation of Borrowing Costs: Borrowing costs may be incurred during an extended period in which the activities necessary to prepare an asset for intended use or sale are interrupted. According to AS-16, “Borrowing Costs”, capitalisation of such borrowing costs should be suspended during extended periods in which active development is interrupted. The standard, however, clarifies that capitalisation of borrowing costs is not suspended when a temporary delay is necessary as a part of the process or substantial technical and administrative work is being carried out. Thus, the test as to whether or not to capitalise the borrowing costs depends primarily upon the nature of interruption of activities during “extended periods”.

In the instant case, it has been mentioned that the construction activity was interrupted due to seasonal rain and hence being regular feature. Though the rain was heavy, the period cannot be considered as an “extended period” leading to substantial delay in suspension of construction activities. Therefore, borrowing cost of ₹12.50 lakhs incurred
by ABC Ltd. should be capitalized. Hence, suspension of capitalization by the company is not a correct treatment and statutory auditor should report accordingly.

(b) **Branch Auditor’s Report:** As per provisions of the Companies Act, 2013, the accounts of a branch office of a company are required to be audited either by the company’s auditor or by any other person qualified for appointment as auditor of the company. It is not necessary for branch auditor M/s XYZ to visit the branch and conduct the audit only at branch’s premises. It is a matter of professional judgement for the branch auditor to decide as to whether he needs to visit the branch. At the same time, the statutory auditor has the right to visit branch offices and to have access to the books of accounts and vouchers maintained at the branch office in this case.

In any case, the principal auditor i.e. the statutory auditor of Head Office P Ltd. is entitled to rely on the work of branch auditor unless there are special circumstances to make it essential for him to visit the branch and examine the books of account and voucher records. As per basic principles governing an audit, the principal auditor is entitled to rely upon the work performed by others provided he exercises adequate skill and care and is not aware of any reason to believe that he should not have so relied. As per SA 600, “Using the work of another auditor”, the principal auditor is not required to evaluate professional competence because branch auditor happens to be member of ICAI. The statutory auditor is also required to deal with the Branch Auditor’s report in the manner, he considers necessary. Therefore, the statutory auditor is required to deal with M/s XYZ’s report in the manner it considers fit under the circumstances.

(c) **Revenue Recognition:** As per the definition of the term “Revenue” in AS 9, “Revenue Recognition”, revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them.

As per the clarification issued by ICAI, the use of the word “enterprise” in the above definition clearly implies that the transfers within the enterprise cannot be considered as fulfilling the definition of the term “revenue”. Thus, the recognition of inter-divisional transfers as sales is an inappropriate accounting treatment and is inconsistent with AS 9. Further, in case of inter-divisional transfers, risks and rewards remain within the enterprise and also there is no consideration from the point of view of the enterprise as a whole. Thus, the recognition criteria for revenue recognition are also not fulfilled in respect of inter-divisional transfers.

In the instant case, therefore, LM Ltd cannot recognise inter-division transfers from L to M as sales and the same will have to be eliminated during finalisation. If not so done, the statutory another will have to qualify his report.

(d) **Applicability of Accounting Standard:** AS 20, “Earning Per Share”, came into effect in respect of accounting periods commencing on or after 1-4-2001 and is mandatory in nature, from that date, in respect of enterprises whose equity shares or potential equity
shares are listed on a recognised stock exchange in India. As such AS 20 does not mandate an enterprise, which has neither equity shares nor potential equity shares which are so listed, to calculate and disclose earnings per share, but, if that enterprise discloses earnings per share for complying with the requirements of any statute or otherwise, it should calculate and disclose earnings per share in accordance with AS 20. Part II of Schedule III to the Companies, Act, 2013, requires, among other things, disclosure of earnings per share. Accordingly, every company, which is required to give information under Part II of Schedule III to the Companies Act, 2013, should calculate and disclose earnings per share in accordance with AS 20, whether or not its equity shares or potential equity shares are listed on a recognised stock exchange in India.

Accordingly, the company, T Pvt. Ltd should compute and disclose EPS according to AS 20. Therefore, the contention of Director (Finance) is incorrect. The auditor will have to ensure that EPS is disclosed as per AS 20 or else the auditor should appropriately modify the audit report.

Question 30
As a Statutory Auditor, how would you deal with the following:

(a) P Pvt. Ltd. was amalgamated with PQR Ltd. with effect from 1st April, 2015. As per the scheme of amalgamation approved by the High Court, the amalgamation was to be accounted by the “Pooling of Interests Method”. The scheme further provided that the balance in Revaluation Reserve of P Pvt. Ltd. as on 31st March, 2015 was to be treated as a General Reserve on amalgamation. During the financial year 2015-16, PQR Ltd. issued bonus shares out of General Reserves (which included the amount of revaluation reserve of P Pvt. Ltd.)

(b) B Pvt. Ltd., implements a Voluntary Retirement Scheme (VRS) for its employees. It follows a policy of amortising the expenditure over 10 years. As at 1st April, 2015, the unamortised VRS expenditure was ₹ 15 lakhs. During the year 2015-16, it incurred further ₹ 12 lakhs as VRS. For the year ended 31st March, 2016, the company proposes to revise the period of amortisation to 5 years. It also proposes to follow the revised period for the opening balance.

Answer

(a) **Amalgamation and Revaluation Reserve:** As per AS 14, “Accounting for Amalgamations” if the amalgamation is in the nature of merger and the ‘Pooling of Interest Method’ is followed, the identity of the reserves is preserved and it appears in the financial statements of the transferee company in the same form in which they appeared in the financial statements of the transferor company. In the instant case, P Pvt. Ltd. is amalgamated with PQR Ltd. and the amalgamation is in the nature of merger. Accordingly, Revaluation Reserves of P Pvt. Ltd. would have normally continued to remain so in PQR Ltd. However, since the scheme mentions that Revaluation Reserve is to be treated as General Reserves, the scheme will override AS 14. AS 14, “Accounting for Amalgamations”, also requires that in case of any approved scheme of amalgamation if the treatment in accounting is not as per the AS, a specific disclosure of the same will have to be made alongwith the financial statements.
effect on the financial statements due to such deviation. The statutory auditor will accordingly have to ensure that the company complies with the requirements regarding treatment of reserves and other related disclosure requirements or he may be required to modify his report.

(b) Expenditure on Voluntary Retirement Scheme: AS 26, “Intangible Assets”, deals with expenditure incurred on intangible items by all enterprises, except amongst others, is not applicable to expenditure in respect of termination benefits. As per the standard, termination benefits are employee benefits payable as a result of either an enterprises’ decision to terminate an employee’s employment before the normal retirement date; or an employee’s decision to accept voluntary redundancy in exchange for those benefits (voluntary retirement). Accordingly, Voluntary Retirement Scheme (VRS) is one form of termination benefit and hence AS 26 principles are not applicable. The same has to be, therefore, accounted as per general accepted accounting practices. Accordingly, VRS expenditure would have to be written off / amortised over a reasonable period. In fact, the change of the accounting policy followed by the company to reduce the amortisation period to 5 years for the entire VRS expenditure including opening balance seems appropriate and reasonable. The auditor, however, has to examine that the requirements of AS 5, “Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies” and impact of change in accounting policy is also disclosed as per AS 1, “Disclosure of Accounting Policies”.

Question 31

When can a company be said to have ‘Not maintained’ proper books of account? What is the role of the statutory auditor for the same?

Answer

Proper Books of Account Not Maintained: Section 128(1) of the Companies Act, 2013 requires that every company shall prepare and keep at its registered office books of account and other relevant books and papers and financial statement for every financial year which give a true and fair view of the state of the affairs of the company, including that of its branch office or offices, if any, and explain the transactions effected both at the registered office and its branches and such books shall be kept on accrual basis and according to the double entry system of accounting.

The provisions mentioned above are required to be followed by the company to maintain proper books of accounts. The Auditor is required to check that the company has complied with all the provisions related to maintenance of books of accounts etc.

Further, the books have to be maintained under accrual system and if the statutory auditor finds the books are not maintained accordingly, he will have to modify his report.

According to Section 143(3)(b), the auditor’s report shall also state whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books and proper returns adequate for the purposes of his audit have been received from branches not visited by him.
If answer is in negative or with qualification, the report shall state the reasons therefor.

**Question 32**

A Ltd. is a Chennai based company. The total turnover of the company is ₹10 crores for the year 2015-16. The company has a branch office at an area which was recently affected by flood. The transportation services are not available due to destruction caused by flood. The branch office recorded turnover of ₹1,50,000 in the Financial Year 2015-16. No audit of branch has been carried out. The statutory auditor of the company has made no reference of the above branch in his report. Comment.

**Answer**

**Branch Audit:** As per section 143(8) of the Companies Act, 2013 if a company has a branch office, the accounts of that office shall be audited either by the auditor appointed for the company (herein referred to as the company’s auditor) under this Act or by any other person qualified for appointment as an auditor of the company under this Act and appointed as such under section 139, or 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.

In the given situation, A Ltd. is a Chennai based company, having total turnover of ₹10 Crore. The company is having a branch office at an area which is recently affected by flood.

Therefore, the company has to get its branch audited. In case no branch audit has been carried out, company’s auditor is required to mention this fact in the audit report and deal appropriately. Thus, no reference of above branch in statutory auditor’s report is not correct.

**Question 33**

What are your views on the following:

(a) **Kevin Industries Ltd.** has a paid up capital of ₹20 crores divided into equity shares of ₹10 each as on 31.03.2015. During the financial year 2015-16 it has issued bonus shares in the ratio 1 : 1. The net profit after tax for the years 31-03.2015 and 31.3.2016 is ₹10 crores and ₹15 crores respectively. The Earnings Per Share (EPS) disclosed in the financial statements for the above two years is ₹5.00 and ₹3.75 respectively. Is the disclosure correct?

(b) A firm of a father and a son is receiving ₹2 lakhs towards job work done for XYZ Ltd. during the year ended on 31.03.16. The total job work charges paid by XYZ Ltd. during the year are over ₹50 lakhs. The father is a Managing Director of XYZ Ltd. having substantial holding. The Managing Director told the auditor that since he is not involved in the activities of the firm and since the amount paid to it is insignificant; there is no need to disclose the transaction. He further contended that such a payment made in the last year was not disclosed. Is Managing Director right in his approach?
6.30  Advanced Auditing and Professional Ethics

Answer

(a) **Disclosure of Earnings Per Share:** AS 20 on Earnings Per Share (EPS) prescribes principles for the determination and presentation of EPS. As per AS 20, the earnings per share have to be disclosed as basic and diluted earnings per share on the face of the Statement of Profit and Loss for each class of equity shares that has a different right to share in the net profit for the period. In the instant case, Kevin Industries Ltd., both the basic as well as the diluted earnings per share would be the same since there are no dilutive instruments that have been issued by the company. As per AS 20, in the case of a bonus issue, equity shares are issued to existing shareholders for no additional consideration and thus would lead to increase in number of equity shares without any adjustment to outstanding capital amount. Therefore, the number of equity shares outstanding is increased without an increase in resources. The standard further requires that the number of equity shares outstanding before the event of a bonus issue to be adjusted for the proportionate change in the number of equity shares outstanding as if the event had occurred at the beginning of the earliest period reported. Hence the EPS calculated as on 31-03-2015 would be Adjusted EPS and the same would be disclosed. In view of the above, the EPS will be calculated as under:

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<th>Profits</th>
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<tr>
<td>As on 31.03.2015</td>
<td>Adjusted No. of Shares</td>
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<td></td>
<td>10,00,00,000</td>
<td>₹ 2.5</td>
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<tr>
<td>As on 31.03.2016</td>
<td>No. of shares</td>
<td>EPS</td>
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<td></td>
<td>15,00,00,000</td>
<td>₹ 3.75</td>
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Since the above figures of EPS have not been disclosed, Kevin Industries Ltd. has not complied with the provisions of AS 20. Therefore, the auditor would have to qualify his report in terms of section 143(3)(e) of the Companies Act, 2013.

(c) **Related Party Disclosures:** As per definition given in the AS 18 “Related Party Disclosures” parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions. Related party transaction means a transfer of resources or obligations between related parties, regardless of whether or not a price is charged.

In the instant case, the managing director of XYZ Ltd. is a partner in the firm with his son which has been paid ₹ 2 lakhs as job work charges. The managing director is having a substantial holding in XYZ Ltd. The case is squarely covered by AS 18. According to AS-18, in the case of related party transactions, the reporting enterprise should disclose the following:
(i) the name of the transacting related party;
(ii) a description of the relationship between the parties;
(iii) a description of the nature of transactions;
(iv) volume of the transactions either as an amount or as an appropriate proportion;
(v) any other elements of the related party transactions necessary for an understanding of the financial statements;
(vi) the amounts or appropriate proportions of outstanding items pertaining to related parties at the balance sheet date and provisions for doubtful debts due from such parties at that date; and
(vii) amounts written off or written back in the period in respect of debts due from or to related parties."

Further, SA 550 on “Related Parties”, also prescribes the auditor’s responsibilities and audit procedures regarding related party transactions.

The approach of the managing director is not tenable under the law and accordingly all disclosure requirements have to be complied with in accordance with the AS 18. Auditor should insist to make proper disclosure as per the AS and if management refuses, the auditor shall have to modify his report. Also it has to be seen whether section 184 of the Companies Act, 2013 regarding disclosure of interest by director has been complied with. If it is not complied with, the auditor needs to modify the report appropriately.

Question 34
Do you approve of the following? If not, why?
(a) Trimurthy Pan Masala (P) Ltd. was incurring heavy losses in the last several years since it could not withstand the competition in the market. The State in which the company had its registered office and also its major sales had moved a bill in the State Assembly to ban manufacture and sale of all kinds of Pan Masalas in the State. While finalizing the accounts for the year ended 31-03-2016, the CFO of the company created a Deferred Tax Asset for the tax benefits that would arise in future years from the earlier years losses that had remained unabsorbed in Income Tax.

(b) Big Ltd. has borrowed ₹ 30 lakhs from State Bank of India during the financial year 2015-16. The borrowings are used to invest in shares of Small Ltd., a subsidiary company of Big Ltd., which is implementing a new project estimated to cost ₹ 50 lakhs. As on 31st March, 2016, since the said project was not complete, the directors of Big Ltd. resolved to capitalize the interest accruing on borrowings amounting to ₹ 4 lakhs and add it to the cost of investments.

Answer
(a) Creation of Deferred Tax Asset: Accounting Standard 22 on “Accounting for Taxes” requires that Deferred Tax Asset (DTA) should be recognised for all timing differences, subject to the considerations of prudence. The Standard further states that unabsorbed
losses of the business can be considered for creation of DTA provided there is virtual certainty supported by convincing evidence that sufficient future taxable income will be available against which such DTA can be realised. In view of this, the DTA created by the CFO of Trimurthy Pan Masala (P) Ltd. is not in order. Since the company which is in the business of manufacturing of panmasala has been incurring heavy losses and in addition to this the State in which the company is having its major sales is proposing the ban on sale and manufacture of pan masala, the statutory auditor would, therefore, have to qualify his report and mention the extent of amounts of loss and reserves which are under and overstated respectively.

(b) Capitalisation of Interest: As per AS 13 on “Accounting for Investments”, the cost of investment includes acquisition charges such as brokerage, fees and duties. In the instant case, Big Ltd. has used borrowed funds for purchasing shares of its subsidiary company Small Ltd. ₹ 4 lakhs interest payable by Big Ltd. to State Bank of India cannot be called as cost of investment. The Accounting Standard 16 on “Borrowing Costs” also does not consider investment in shares as qualifying asset that can enable a company to add the borrowing costs to investments. In the instant case, the statutory auditor would qualify his report by stating that the borrowing costs have been wrongly added to the cost of investments rather than charging them to Statement of Profit and Loss. The effect of the same on the profits for the year would also have to be mentioned.

Question 35

Miranda Spinning Mills Ltd. is a sick company and has accumulated losses of ₹ 10 crores. The company has ₹ 12 crores in its share Premium Account. The Management desires to adjust the accumulated losses against the share premium balance. Advise the company giving your reasons.

Answer

Application of Share Premium Account: Section 52 of the Companies Act, 2013 (herein after referred as the Act) deals with the application of premium received on issue of shares. Sub-section (1) of the said section provides that where a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount of the premium received on those shares shall be transferred to an account called “Securities Premium Account” and the provisions of this Act relating to reduction of share capital of a company except as provided in this section shall apply as if the securities premium account was the paid up share capital of the company. Sub-section (2) of the said section provides that notwithstanding anything contained in sub-section (1), securities premium account may be applied by the company for issue of bonus shares; writing off the preliminary expenses; writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company; in providing for the premium payable on redemption of any redeemable preference shares or any debentures of the company; for the purchase of its own shares or other securities. In view of these provisions of the Companies Act, 2013, it is not permitted to adjust its accumulated losses against the securities premium account.
Question 36

Write a short note on Responsibility of Joint Auditors.

Answer

Responsibility of Joint Auditors: SA 299 on, “Responsibility of Joint Auditors” deals with the professional responsibilities which the auditors undertake in accepting such appointments as joint auditors. The responsibilities of joint auditors, as a rule are no different from the responsibilities of individual auditors as enumerated in the Companies Act. Main features of the said SA are discussed below:

(i) Division of Work: Where joint auditors are appointed, they should, by mutual discussion, divide the audit of identifiable units or specified areas. Certain areas of work, owing to their importance or owing to the nature of work involved would not be divided and would be covered by all the joint auditors. Such a division affected by the joint auditors should be adequately documented and preferably communicated to the auditee.

(ii) Coordination: Where in the course of his work, a joint auditor comes across matters which are relevant to the areas of other joint auditors and which require joint discussion, he should communicate the same to all the other joint auditors in writing before the finalisation of audit and preparation of audit report.

In respect of the work divided amongst the joint auditors, each joint auditor is responsible only for the work allocated to him, whether or not he has made a separate report on the work performed by him. On the other hand the joint auditors are jointly and severally responsible in respect of the audit conducted by them as under:

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

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

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

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

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

(vi) It is the separate and specific responsibility of each joint auditor to study and evaluate the prevailing system of internal control relating to the work allocated to him, the extent of enquiries to be made in the course of his audit.

(vii) The responsibility of obtaining and evaluating information and explanation from the management is generally a joint responsibility of all the auditors.

(viii) Each joint auditor is entitled to assure that the other joint auditors have carried out their part of work in accordance with the generally accepted audit procedures and therefore it
would not be necessary for joint auditor to review the work performed by other joint auditors.

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

Question 37

In the books of accounts of M/s OPQ Ltd. huge differences are noticed between the control accounts and subsidiary records. The Chief Accountant informs that this is common due to huge volume of business done by the company during the year. As a Statutory Auditor, how would you deal?

Answer

Difference between Control Accounts and Subsidiary Records: The huge differences found between control accounts and subsidiary records in the books of M/s OPQ Ltd. indicate that there may be material misstatements requiring detailed examination by the auditor to ascertain the cause. The contention of Chief Accountant cannot be accepted simply because the company has done huge volume of business. Such a phenomenon indicates that recording of transactions is not being done properly or the accounting system in the company which might have several branches spread over the country fails to capture all transactions in time. It would also be interesting to see whether it is a recurring phenomenon or such reconciliation could not be done at a subsequent date. Having regard to all these circumstances, it appears from the facts of the case that these differences indicate the possibility of some kind of material misstatements. As per SA 240, “The Auditor’s Responsibilities relating to Fraud in an Audit of Financial Statements”, when the auditor identifies a misstatement, the auditor shall evaluate whether such a misstatement is indicative of fraud. If there is such an indication, the auditor shall evaluate the implications of the misstatement in relation to other aspects of the audit, particularly the reliability of management representations, recognizing that an instance of fraud is unlikely to be an isolated occurrence. When the auditor confirms that, or is unable to conclude whether, the financial statements are materially misstated as a result of fraud the auditor shall evaluate the implications for the audit.

Question 38

For the year ended on 31st March, 2016, P Ltd. proposed to pay a dividend of 25% on its equity shares and it further proposed to transfer 20% of Net profit for that year after tax to its reserves. Its auditor objected to the same stating that 10% is the maximum permissible limit to transfer to reserves.

Answer

Transfer to Reserve: Section 123(1) of the Companies Act, 2013 provides that dividend cannot be declared or paid by a company for any financial year except out of profits of the company for that year arrived at after providing for depreciation in accordance with the provisions of Section 123(2),
or out of the profits or the company for any previous financial year or years arrived at after providing for depreciation in the manner aforementioned and remaining undistributed, or out of both.

However, the first proviso to section 123(1) of the said Act provides that a company may, before the declaration of any dividend in any financial year, transfer such percentage of its profit for that financial year as it may consider appropriate to the reserves of the company irrespective of the size of the declared dividend i.e. the company is not mandatorily required to transfer the profit to the reserves, it is an option available to the company to transfer such percentage.

In the instant case, P Ltd. has proposed to pay a dividend of 25% on its equity shares and it further proposed to transfer 20% of Net profit for that year after tax to its reserves.

Therefore, from the above facts and provisions, it may be concluded that P Ltd. is under no violation of law i.e. the company is free to transfer any amount of its profit to the reserves, without any compulsion or restriction, before declaration of any dividend.

Question 39

MG & Co. Ltd. seeks your advice while preparing financial statements the general instructional to be followed while preparing Balance Sheet under Companies Act, 2013 in respect of current assets and liabilities.

Answer

General Instructions for Preparation of Balance Sheet:

(i) General Instruction in respect of Current Assets: An asset shall be classified as current when it satisfies any of the following criteria-

(1) it is expected to be realized in, or is intended for sale or consumption in, the company’s normal operating cycle;

(2) it is held primarily for the purpose of being traded;

(3) it is expected to be realized within twelve months after the reporting date; or

(4) it is cash or cash equivalent unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting date.

(ii) General Instruction in respect of Current Liabilities: A liability shall be classified as current when it satisfies any of the following criteria-

(1) it is expected to be settled in the company’s normal operating cycle;

(2) it is held primarily for the purpose of being traded;

(3) it is due to be settled within twelve months after the reporting date; or

(4) the company does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting date. 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.
Question 40

R and M is an audit firm having partners CA. R, CA. M and CA. G. Mr. S is the relative of CA. R holding shares of STP Ltd. having a face value of ₹ 1,51,000. Whether CA. R and CA. M are qualified to be appointed as auditors of STP Ltd.?

Answer

Holding of Shares by Relative of Partner: As per section 141(3)(d)(i) of the Companies Act, 2013, a person shall not be eligible for appointment as an auditor of a company, who, or his relative or partner is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company. Further as per proviso to this Section, the relative of the auditor may hold the securities or interest in the company of face value not exceeding of ₹ 1,00,000.

In the instant case, R and M is an audit firm having partners CA. R, CA. M and CA. G. Mr. S is a relative of CA. R and he is holding shares of STP Ltd. of face value of ₹ 1,51,000.

Therefore, R and M, audit firm along with its partners CA. R, CA. M and CA. G will be disqualified for appointment as an auditor as the relative of CA. R is holding the securities in STP Ltd. which is exceeding the limit mentioned in proviso to section 141(3)(d)(i).

Thus, CA. R and CA. M will be disqualified to be appointed as auditors of STP Ltd.

Question 41

As an auditor, how would you deal with the following situations:

(a) Ram and Hanuman Associates, Chartered Accountants in practice have been appointed as Statutory Auditor of Krishna Ltd. for the accounting year 2015-2016. Mr. Hanuman, a partner of the Ram and Hanuman Associates, holds 100 equity shares of Shiva Ltd., a subsidiary company of Krishna Ltd.

(b) Nick Ltd. is a subsidiary of Ajanta Ltd., whose 20% shares have been held by Central Government, 25% by Uttar Pradesh Government and 10% by Madhya Pradesh Government. Nick Ltd. appointed Mr. Prem as statutory auditor for the year.

(c) Contravene Ltd. appointed CA Innocent as an auditor for the company for the current financial year. Further the company offered him the services of actuarial, investment advisory and investment banking which was also approved by the Board of Directors.

(d) Mr. Amar, a Chartered Accountant, bought a car financed at ₹ 7,00,000 by Chaudhary Finance Ltd., which is a holding company of Charan Ltd. and Das Ltd. He has been the statutory auditor of Das Ltd. and continues to be even after taking the loan.

Answer

(a) Auditor Holding Securities of a Company: As per sub-section (3)(d)(i) of Section 141 of the Companies Act, 2013 along with Rule 10 of the Companies (Audit and Auditors) Rule, 2014, a person shall not be eligible for appointment as an auditor of a company, who, or his relative or partner is holding any security of or interest in the company or its subsidiary, or of its holding
or associate company or a subsidiary of such holding company. Provided that the relative may hold security or interest in the company of face value not exceeding rupees one lakh.

Also, as per sub-section (4) of Section 141 of the Companies Act, 2013, where a person appointed as an auditor of a company incurs any of the disqualifications mentioned in sub-section (3) after his appointment, he shall vacate his office as such auditor and such vacation shall be deemed to be a casual vacancy in the office of the auditor.

In the present case, Mr. Hanuman, Chartered Accountant, a partner of M/s Ram and Hanuman Associates, holds 100 equity shares of Shiva Ltd. which is a subsidiary of Krishna Ltd. Therefore, the firm, M/s Ram and Hanuman Associates would be disqualified to be appointed as statutory auditor of Krishna Ltd. as per section 141(3)(d)(i), which is the holding company of Shiva Ltd., because Mr. Hanuman one of the partner is holding equity shares of its subsidiary.

(b) According to Section 139(7) of the Companies Act, 2013, the auditors of a government company shall be appointed or re-appointed by the Comptroller and Auditor General of India. As per section 2(45), a Government company is defined as any company in which not less than 51% of the paid-up share capital is held by the Central Government or by any State Government or Governments or partly by the Central Government and partly by one or more State Governments and includes a company which is a subsidiary of a Government Company as thus defined".

In the given case Ajanta Ltd is a government company as its 20% shares have been held by Central Government, 25% by U.P. State Government and 10% by M.P. State Government. Total 55% shares have been held by Central and State governments. Therefore, it is a Government company.

Nick Ltd. is a subsidiary company of Ajanta Ltd. Hence Nick Ltd. is covered in the definition of a government company. Therefore, the Auditor of Nick Ltd. can be appointed only by C & AG.

Consequently, appointment of Mr. Prem is invalid and he should not give acceptance to the Directors of Nick Ltd.

(c) Services not to be Rendered by the Auditor: Section 144 of the Companies Act, 2013 prescribes certain services not to be rendered by the 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 which 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:

(i) accounting and book keeping services;
(ii) internal audit;
(iii) design and implementation of any financial information system;
(iv) actuarial services;
(v) investment advisory services;
(vi) investment banking services;
(vii) rendering of outsourced financial services;
(viii) management services; and
(ix) any other kind of services as may be prescribed.

Further section 141(3)(i) of the Companies Act, 2013 also disqualify a person for appointment as an auditor of a company who is engaged as on the date of appointment in consulting and specialized services as provided in section 144.

In the given case, CA Innocent was appointed as an auditor of Contravene Ltd. He was offered additional services of actuarial, investment advisory and investment banking which was also approved by the Board of Directors. The auditor is advised not to accept the services as these services are specifically notified in the services not to be rendered by him as an auditor as per section 144 of the Act.

(d) According to section 141(3)(d)(ii) of the Companies Act, 2013, a person is not eligible for appointment as auditor of any company, if he is indebted to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company, in excess of rupees five lakh.

In the given case Mr. Amar is disqualified to act as an auditor under section 141(3)(d) as he is indebted to M/s Chaudhary Finance Ltd. for more than ₹ 5,00,000. Also, according to section 141(3)(d)(ii) he cannot act as an auditor of any subsidiary of Chaudhary Finance Ltd. i.e. he is also disqualified to work in Charan Ltd. & Das Ltd. Therefore he has to vacate his office in Das Ltd. Even though it is a subsidiary of Chaudhary Finance Ltd.

Hence audit work performed by Mr. Amar as an auditor is invalid, he should vacate his office immediately and Das Ltd should appoint another auditor for the company.

Question 42

(a) Orange Ltd. is an unlisted public company. Its balance sheet shows paid up share capital of ₹ 5 crore and public deposits of ₹ 100 crore. The company appointed M/s Santra & Co., a chartered accountant firm, as the statutory auditor in its annual general meeting held at the end of September, 2016 for 11 years.

You are required to state the provisions related to - rotation of auditor and cooling off period as per the section 139(2) of the Companies Act, 2013 in case of an individual auditor or an audit firm, both, and comment upon the facts of the case provided above with respect to aforesaid provisions.

(b) MSY & Co. is an Audit Firm having partners CA Mukti, CA Shakti and CA Yukti. CA Mukti, CA Shakti and CA Yukti are holding appointment as an Auditor in 4, 6 and 10 companies respectively.

(i) Provide the maximum number of audits remaining in the name of MSY & Co.

(ii) Provide the maximum number of audits remaining in the name of individual partner i.e. CA Mukti, CA Shakti, CA Yukti.
(iii) Can MSY & Co. accept the appointment as an auditor in 60 private companies having paid-up share capital less than ₹100 crore, 2 small companies and 1 dormant company?

(iv) Would your answer be different, if out of those 60 private companies, 45 companies are having paid-up share capital of ₹110 crore each?

Answer

(a) Rotation of Auditor & Cooling Off Period Provisions: The provision related to Rotation of Auditor & Cooling Off Period is newly inserted by section 139(2) of the Companies Act, 2013 read with Rule 5 of the Companies (Audit & Auditors) Rules, 2014, which is discussed as under:

The provisions related to rotation of auditor are applicable to those companies which are prescribed in Companies (Audit and Auditors) Rules, 2014, which prescribes the following classes of companies excluding one person companies and small companies, namely:-

(i) all unlisted public companies having paid up share capital of ₹10 crore or more;
(ii) all private limited companies having paid up share capital of ₹20 crore or more;
(iii) all companies having paid up share capital of below threshold limit mentioned, but having public borrowings from financial institutions, banks or public deposits of ₹50 crores or more.

As per Section 139(2) of the Companies Act, 2013, no listed company or a company belonging to such class or classes of companies as mentioned above, shall appoint or re-appoint-

(a) an individual as auditor for more than one term of 5 consecutive years; and
(b) an audit firm as auditor for more than two terms of 5 consecutive years.

In the given case, Orange Ltd. is an unlisted public company having paid up share capital of ₹5 crore and public deposits of ₹100 crore. The company has appointed M/s Santra & Co., a
chartered accountant firm, as the statutory auditor in its AGM held at the end of September, 2016 for 11 years.

The provisions relating to rotation of auditor will be applicable as the public deposits exceeds ₹ 50 crore. Therefore, Orange Ltd. can appoint M/s Santra & Co. as an auditor of the company for not more than one term of five consecutive years twice i.e. M/s Santra & Co. shall hold office from the conclusion of this meeting upto conclusion of sixth AGM to be held in the year 2021 and thereafter can be re-appointed as auditor for one more term of five years i.e. upto year 2026. The appointment shall be subject to ratification by members at every annual general meeting of the company. As a result, the appointment of M/s Santra & Co. made by Orange Ltd. for 11 years is void.

(b) **Ceiling on Number of Audit:** 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 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 other than one person companies, dormant companies, small companies and private companies having paid-up share capital less than ₹ 100 crore.

As per section 141(3)(g), 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. Sometimes, a chartered accountant is a partner in a number of auditing firms. In such a case, all the firms in which he is partner or proprietor will be together entitled to 20 company audits on his account.

In the given case, CA Mukti is holding appointment in 4 companies, whereas CA Shakti is having appointment in 6 Companies and CA Yukti is having appointment in 10 Companies. In aggregate all three partners are having 20 audits.

(i) Therefore, MSY & Co. can hold appointment as an auditor of 40 more companies:

\[
\text{Total Number of Audits available to the Firm} = 20 \times 3 = 60
\]

\[
\text{Number of Audits already taken by all the partners in their individual capacity} = 4 + 6 + 10 = 20
\]

\[
\text{Remaining number of Audits available to the Firm} = 40
\]

(ii) With reference to above provisions an auditor can hold more appointment as auditor = ceiling limit as per section 141(3)(g) - already holding appointments as an auditor. Hence (1) CA Mukti can hold: 20 - 4 = 16 more audits. (2) CA Shakti can hold 20-6 = 14 more audits and (3) CA Yukti can hold 20-10 = 10 more audits.

(iii) In view of above discussed provisions MSY & Co. can hold appointment as an auditor in all the 60 private companies having paid-up share capital less than ₹ 100 crore, 2 small companies and 1 dormant company as these are excluded from the ceiling limit of company audits given under section 141(3)(g) of the Companies Act, 2013.

(iv) As per fact of the case, MSY & Co. is already having 20 company audits and they can also accept 40 more company audits. In addition, they can also conduct the audit of one person companies, small companies, dormant companies and private companies having paid up share capital less than rupees 100 crores. In the given case, out of
the 60 private companies, MSY & Co. is offered 45 companies having paid-up share capital of ₹ 110 crore each.

Therefore, MSY & Co. can also accept the appointment as an auditor for 2 small companies, 1 dormant company, 15 private companies having paid-up share capital less than ₹ 100 crore and 40 private companies having paid-up share capital of ₹ 110 crore each in addition to above 20 company audits already holding.

Question 43

(a) Navy and Cavy Associates, a Chartered Accountant firm, has been appointed as Statutory Auditor of Poor Ltd. for the financial year 2015-2016. Mr. Savy, the relative of Mr. Navy, a partner in Navy and Cavy Associates, is indebted for ₹ 6,00,000 to Wealthy Ltd., a subsidiary company of Poor Ltd. Comment.

(b) Mr. Pratiq, a practicing Chartered Accountant, has been appointed as an auditor of Opus Ltd. He is holding securities of the company having face value of ₹ 89,000 only.

(i) You are required to state, whether Mr. Pratiq is qualified to be appointed as an auditor of Opus Ltd.

(ii) Would your answer be different, if instead of Mr. Pratiq; Mr. Quresh, the step-father of Mr. Pratiq, is holding the securities?

Answer

(a) Indebtness to the Subsidiary Company: As per sub-section (3)(d)(ii) of Section 141 of the Companies Act, 2013 along with Rule 10 of the Companies (Audit and Auditors) Rule, 2014, a person shall not be eligible for appointment as an auditor of a company, who, or his relative or partner is indebted to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company, in excess of ₹ 5 lakhs.

Also, as per sub-section (4) of Section 141 of the Companies Act, 2013, where a person appointed as an auditor of a company incurs any of the disqualifications mentioned in sub-section (3) after his appointment, he shall vacate his office as such auditor and such vacation shall be deemed to be a casual vacancy in the office of the auditor.

In the present case, Mr. Savy, the relative of Mr. Navy, a partner in Navy and Cavy Associates, has been indebted to Wealthy Ltd., a subsidiary company of Poor Ltd., for ₹ 6 lakhs.

Therefore, the firm, Navy and Cavy Associates would be disqualified to be appointed as statutory auditor of Poor Ltd. as per section 141(3)(d)(iii), which is the holding company of Wealthy Ltd., because Mr. Savy, the relative of Mr. Navy, a partner in Navy and Cavy Associates, has been indebted to Wealthy Ltd. for an amount exceeding the minimum approved limit.

(b) Disqualification due to Holding of Securities: According to section 141(3)(d)(i) of the Companies Act, 2013 read with Rule 10 of the Companies (Audit and Auditors) Rule, 2014, an auditor is disqualified to be appointed as an auditor if he, or his relative or partner holding
any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company.

However, as per the proviso to this Section, the relative of the auditor may hold the securities or interest in the company of face value not exceeding of ₹ 1,00,000.

Further, the term “relative” has been defined under the Companies Act, 2013 which means anyone who is related to another as members of a Hindu Undivided Family; husband and wife; Father (including step-father), Mother (including step-mother), Son (including stepsong), Son’s wife, Daughter, Daughter’s husband, Brother (including step-brother), Sister (including step-sister).

In the present situation,

(i) Mr. Pratiq is holding securities in Opus Ltd., which is not allowed as per the provisions of section 141(3)(d)(i) of the Act. Therefore, Mr. Pratiq will be disqualified to be appointed as an auditor of Opus Ltd.

(ii) Mr. Quresh, the step-father of Mr. Pratiq, is holding the securities in Opus Ltd.

It may be noted that step-father is included in the definition of the term “relative” as per the Companies Act, 2013. Further, proviso to section 141(3)(d)(i) of the Act allows a relative of the auditor to hold securities in the company of face value not exceeding of ₹ 1,00,000.

Here, Mr. Quresh is holding securities for face value of ₹ 89,000 which is below the limit as prescribed under the said proviso.

Therefore, Mr. Pratiq will not be disqualified to be appointed as an auditor of Opus Ltd.

Question 44

Gracious Ltd. has made a contribution of ₹ 7.8 lacs during the financial year ended 31.3.16 to Samaj Seva Party, a political party, for running a teaching institute situated in the rural area, where most of the workers of the company reside. It is admitted that the benefit of the institute is mostly for the children of the workers of the company. The average net profit of the company during the three immediately preceding financial years was ₹ 100 lakhs. Comment.

Answer

Restrictions Regarding Political Contribution: Section 182 of the Companies Act, 2013 deals with prohibitions and restrictions regarding political contributions. According to this section, a government company or any other company which has been in existence for less than three financial years cannot contribute any amount directly or indirectly to any political party. In other cases, aggregate contribution in any financial year should not exceed 7½ % of average net profit during the three immediately preceding financial years.

In the given case, Gracious Ltd. has made a contribution of ₹ 7.8 lacs to Samaj Seva Party, a political party. The average net profit of the company during the three immediately preceding financial years is ₹ 100 lakhs and the 7½ % of this works out to ₹ 7.5 lacs.
As the company has contributed ₹ 7.8 lacs, there is a violation of the provisions of Section 182 of the Companies Act, 2013 although the children of its workers are benefited. Therefore, the auditor would have to qualify his report accordingly.

Question 45

(a) CA Adroit was indebted to Anfractuous (P) Ltd. for a sum of ₹ 6,00,000 as on 01.04.2016. However, CA Adroit having come to know that he might be appointed as auditor of the company, he squared up the amount on 10.7.2016. Later on, he was appointed as an auditor of the company for the year ended 31.3.2017 at the Annual General Meeting held on 16.07.2016.

Subsequently, one of the shareholders complains that the appointment of CA Adroit as an auditor is invalid because he incurred disqualification under section 141 of the Companies Act, 2013. Comment.

(b) While auditing Y Ltd., CA Max, the statutory auditor of Y Ltd. encounters exceptional circumstances that bring into question his ability to continue performing the audit. Considering it appropriate, CA Max resigned from the office of auditor of Y Ltd. Due to the resignation of the existing auditor, the Board of Directors of Y Ltd. itself appointed CA Mini, a practicing Chartered Accountant, as the statutory auditor till the conclusion of 6th meeting.

You are required to state the provisions related to filling of casual vacancy as per the Companies Act, 2013 and comment upon the validity of appointment made by the Board.

(c) Malta Pvt. Ltd., a newly incorporated company dated 01.07.2016 is engaged in the manufacturing business of Cotton Shirts. On 30.07.2016, the Managing Director of Malta Pvt. Ltd. himself appointed CA Rajnath, his daughter’s husband, as the first auditor of the company.

You are required to –

(i) state the provisions of the Companies Act, 2013 relating to appointment of first auditor.
(ii) comment on the action of the Managing Director.

Answer

(a) Indebtness to the Company: According to the section 141(3)(d)(ii) of the Companies Act, 2013, a person who is indebted to the company for an amount exceeding ₹ 5,00,000 shall be disqualified to act as an auditor of such company and further under section 141(4) he shall vacate his office of auditor when he incurs this disqualification subsequent to his appointment.

However, where the person has liquidated his debt before the appointment date, there is no disqualification to be construed for such appointment.

In the given case, CA Adroit was indebted to Anfractuous (P) Ltd. for a sum of ₹ 6,00,000 as on 01.04.2016. He was appointed as an auditor of the company for the year ended 31.03.2017 at the Annual General Meeting held on 16.07.2016. He also repaid the loan amount fully to the company on 10.7.2016 i.e. before the date of his appointment.
Hence, the appointment of CA Adroit as an auditor is valid and the shareholder’s complaint is not acceptable.

(b) Filling of Casual Vacancy: According to section 139(8) of the Companies Act, 2013, any casual vacancy in the office of an auditor shall-

(i) In the case of a company other than a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India, be filled by the Board of Directors within 30 days.

If such casual vacancy is as a result of the resignation of an auditor, such appointment shall also be approved by the company at a general meeting convened within 3 months of the recommendation of the Board and he shall hold the office till the conclusion of the next annual general meeting.

(ii) In the case of a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India, be filled by the Comptroller and Auditor-General of India within 30 days.

It may be noted that in case the Comptroller and Auditor-General of India does not fill the vacancy within he said period the Board of Directors shall fill the vacancy within next 30 days.
In the given case, CA Max, the statutory auditor of Y Ltd. has resigned from the office of auditor. Therefore, such casual vacancy can be filled by the Board of Directors subject to approval by the company at a general meeting convened within 3 months of the recommendation of the Board.

Thus, the appointment of CA Mini made by the Board of Directors without the approval of the company at a general meeting is invalid.

Further, if appointment is approved by the company, CA Mini cannot hold the office of auditor till the conclusion of 6th meeting i.e. the appointment cannot be made for five years. The auditor can hold office only till the conclusion of the next AGM.

(c) (i) Appointment of First Auditor: Provisions of the Companies Act, 2013 relating to appointment of first auditor are stated below-

1. **Appointment of First Auditor in the case of a company, other than a Government Company:** As per Section 139(6), the first auditor of a company, other than a Government company, shall be appointed by the Board of Directors within 30 days from the date of registration of the company.

   In the case of failure of the Board to appoint the auditor, it shall inform the members of the company.

   The members of the company shall within 90 days at an extraordinary general meeting appoint the auditor. Appointed auditor shall hold office till the conclusion of the first annual general meeting.

2. **Appointment of First Auditor in the case of Government Company:** Section 139(7) provides that 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, the first auditor shall be appointed by the Comptroller and Auditor-General of India within 60 days from the date of registration of the company.

   In case the Comptroller and Auditor-General of India does not appoint such auditor within the above said period, the Board of Directors of the company shall appoint such auditor within the next 30 days. Further, in the case of failure of the Board to appoint such auditor within next 30 days, it shall inform the members of the company who shall appoint such auditor within 60 days at an extraordinary general meeting. Auditors shall hold office till the conclusion of the first annual general meeting.
(ii) **Appointment of First Auditor by the Managing Director:** Apparently, there are two issues arising out of the situation given in the question, viz., first one relates to appointment of first auditor by the Managing Director; and second pertains to relation of such an auditor with the Managing Director. Regarding the first issue relating to appointment of auditor, particularly, in this case relating to appointment of first auditor, it may be noted that as per the provisions of section 139(6) of the Companies Act, 2013, the first auditor of a company shall be appointed by the Board of Directors within 30 days from the date of registration of the company.

As per the facts given in the case, the appointment of CA Rajnath as first auditor by the Managing Director of Malta Pvt. Ltd. by himself is in violation of section 139(6) of the Companies Act, 2013, which authorizes the Board of Directors to appoint the first auditor of a company within one month of registration of the company.

Thus, the appointment of CA Rajnath is not valid. Under the circumstances, the second issue relating to relationship of auditor with Managing Director becomes redundant.

**Question 46**

Comment on the following situations:

(a) The Board of Directors of Polite Ltd. made an aggregate of online contribution of ₹ 37.5 lakhs to a National Defence Fund for the financial year ending on
31st March, 2016. All the contribution of the fund is used for the welfare of the members of the Armed Forces and their dependents. The average net profit of the company during the three immediately preceding financial years was ₹ 476 lakhs.

The manager of the company is of the view that the maximum contribution that can be made to a National Defence Fund is ₹ 35.7 lakhs and, therefore, the company is violating the provisions of the Companies Act, 2013.

(b) Pirana Ltd. issued 10,000 shares of face value of ₹ 10 each at a premium of ₹ 490 each in May, 2016. The company received the stated minimum amount in the prospectus and transferred a sum equal to the aggregate amount of the premium received on shares (i.e. ₹ 49 lakhs) to the ‘Securities Premium Account’.

Unfortunately, in the month of July, the godown of the company caught fire and stock worth ₹ 45 lakhs burnt to ashes.

Now, the management desires to adjust the loss due to fire against the said premium account.

Answer

(a) Contribution to National Defence Fund: Section 183 of the Companies Act, 2013 deals with the power of Board and other persons to make contributions to National Defence Fund, etc. This section permits the Board and other person to make contributions to the National Defence Fund or any other Fund approved by the Central Government for the purpose of National Defence to any extent as it thinks fit.

In the given case, the board of Polite Ltd. has made an aggregate of online contribution of ₹ 37.5 lakhs to a National Defence Fund. However, according to the manager of Polite Ltd., the maximum contribution that can be made to the Fund is ₹ 35.7 lakhs.

In this context, it may be noted that there is no such restriction imposed on contributions to National Defence Fund. The board is free to contribute such amount as it thinks fit.

Therefore, the view of the manager of Polite Ltd. is not appropriate and, thus, there is no such violation of the provisions of section 183 of the Companies Act, 2013. The data on average net profit of the company given in question is of no relevance here.

(b) Application of Securities Premium Account: Section 52 of the Companies Act, 2013 (herein after referred as the Act) deals with the application of premium received on issue of shares. The said section provides that where a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount of the premium received on those shares shall be transferred to an account called “Securities Premium Account” and the provisions of this Act relating to reduction of share capital of a company except as provided in this section shall apply as if the securities premium account was the paid up share capital of the company.

However, as per section 52, the securities premium account may be applied for the following purposes:

(i) towards the issue of fully paid bonus shares;
(ii) in writing off the preliminary expenses;
(iii) in writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures;
(iv) in providing for the premium payable on the redemption of any redeemable preference shares or debentures; or
(v) for the purchase of its own shares or other securities under section 68 of the Companies Act, 2013.

In the given case, the management of Pirana Ltd. desires to adjust the loss due to fire against the securities premium account.

In view of the above provisions of the Companies Act, 2013, it may be noted that the company is not permitted to adjust its loss against the securities premium account.

Question 47

IT Limited has prepared the financial statements for the year 2015-16 and mentioned in the significant accounting policies that depreciation on tangible fixed assets is provided on the straight line method over the useful lives of the assets as estimated by the management. The company has ignored the useful lives of assets mentioned in Schedule II of the Companies Act, 2013. As statutory auditor of the company how would you deal with this?

Answer

Providing Depreciation ignoring Schedule II to the Companies Act, 2013: Section 129 of the Companies Act, 2013, requires that the financial statements shall give a true and fair view of the state of affairs of the company and are in compliance with Accounting Standards.

Further, as per Schedule II to the Companies Act, 2013 on ‘Useful Lives to Compute Depreciation’, the useful life of an asset shall not ordinarily be different from the useful life specified therein.

However, if such a company uses a useful life of the asset which is different from the above limits, it shall disclose the justification for the same in its financial statement.

In the given case, IT Limited has mentioned in the significant accounting policies that the depreciation on tangible fixed assets is provided on the straight line method over the useful lives of the assets as estimated by the management and ignored the useful lives of the assets as provided under Schedule II to the Companies Act, 2013.

Therefore, the statutory auditor of the company should ensure that the management has disclosed the justification for consideration of different useful life of the assets from that as indicated under Schedule II. If the justification has not been provided then the auditor of the company shall suggest the management for the same and if management refuses, the auditor should qualify his report accordingly.
Question 48

KSY & Co., Chartered Accountants, is an audit firm having two partners CA K and CA Y. KSY & Co. is already holding appointment as auditors of 36 public companies and none of the partners hold any company audits in their personal capacity or as partners with another firm.

KSY & Co. seeks your advice in the following situations:

(i) KSY & Co. has been offered the appointment as Auditors of 7 more Private Limited Companies. Of the seven, one is a company with a paid up share capital of ₹150 crores, five are "Small companies" as per the Act and one is a "Dormant Company".

(ii) Would your answer be different, if out of those 7 Private Companies, 3 Companies have paid up capital of ₹90 crores each?

Answer

Ceiling Limit for Holding 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 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 20 companies other than one person companies, dormant companies, small companies and private companies having paid-up share capital less than ₹100 crore.

In the instant case, KSY & Co. is an audit firm having two partners, namely, CA. K and CA. Y. The total number of company audits that can be accepted by the firm is 40 (2 partners x 20 companies each partner). However, the firm is already holding appointment as auditors of 36 public companies. Thus, the remaining number of audits that can be accepted by the firm is of 4 more companies.

(i) In the given situation, KSY & Co. has been offered appointment as auditors of 7 private limited companies out of which 1 is a private limited company with paid up share capital of ₹150 crores, 5 are ‘small companies’ and 1 is ‘dormant company’.

In view of above discussed provisions and explanations, KSY & Co. can hold appointment as an auditor in 5 ‘small companies’ and 1 ‘dormant company’ as these are excluded from the ceiling limit of company audits.

In addition, the firm can also accept appointment as auditor of 1 private limited company with paid-up share capital of ₹150 crores which will be within the maximum ceiling limit of 40 company audits.

Therefore, KSY & Co. can accept appointment for all the 7 private limited companies as asked in question.

(ii) No, answer will not be different in the given situation, where KSY & Co. has been offered appointment as auditors of 7 private limited companies out of which 3 companies have paid-up share capital of ₹90 crores.

In view of above discussed provisions and explanations, KSY & Co. can hold appointment as an auditor in all the private companies as 3 private companies are having
paid-up share capital of ₹90 crores which are exempted as per the provisions of the Companies Act, 2013, therefore, excluded from the ceiling limit of company audits and other 4 private companies will also be within the maximum ceiling limit of 40 company audits even if the paid-up share capital is ₹100 crore or more.

Question 49

IO Ltd. is registered with Registrar of Companies on 1st of May 2015. The Company’s 27% of paid up share capital is held by Central Government; 28% by State Government and the remaining 45% by public. The Board of Directors appointed RMG, Chartered Accountants as statutory auditors for the financial year 2015-16 by passing a resolution at the Board Meeting held on 25th May, 2015.

Comment whether appointment is valid or not.

Answer

Appointment of First Auditor of a Government Company: According to section 139(7) of the Companies Act, 2013, the first auditor of a government company shall be appointed by the Comptroller and Auditor-General of India within 60 days from the date of registration of the company. As per section 2(45) of the said Act, a Government Company is defined as any company in which not less than 51% of the paid-up share capital is held by the Central Government or by any State Government or Governments or partly by the Central Government and partly by one or more State Governments and includes a company which is a subsidiary company of such a Government Company.

In the given case, IO Ltd. is a government company as its 27% of paid-up share capital has been held by Central Government, 28% by State Government and remaining 45% by Public i.e. total 55% of the paid-up share capital has been held by Central Government and State Government which is more than 51% as prescribed in the Companies Act, 2013.

Therefore, the appointment of RMG, Chartered Accountants as first auditor by the Board of Directors of IO Ltd. for the financial year 2015-16 is not valid as the first auditor of a government company can be appointed by Comptroller and Auditor-General of India. If the CAG fails to make such appointment within 60 days, the Board of Directors shall appoint within next 30 days.

Question 50

The Board of Directors of ACP Ltd. has recommended the dividend of 15% on paid up share capital of ₹450 crore for the year ended 31st March, 2016, at their meeting held on 1st of May, 2016 when the accounts for the financial year 2015-16 were approved. The Board of Directors when they met on 7th July, 2016 for the review of first quarter accounts, they realized that results were negative for the first quarter. Therefore, the Board has decided to rescind their decision to recommend dividend.

The notice for AGM to be held on 14.8.2016 was sent on 15th July, 2016 without any recommendation for dividend.

At the AGM, the members asked the management how they can rescind the declaration of dividend once recommended. Comment.
Answer

Decision to rescind the Recommended Dividend: Dividend is firstly recommended by the Board. Thereafter, the members in the Annual General Meeting (AGM) may declare the dividend by passing ordinary resolution. The members may reduce the rate or amount recommended by the Board, but they cannot increase it.

Section 123 of the Companies Act, 2013, provides that the dividend shall be declared or paid by a company for any financial year out of the profits of the company for that year arrived at after providing for depreciation in prescribed manner.

Further, as per section 127 of the Act, dividends once declared become the liability of the company and must be paid within 30 days from the date of declaration. Any failure to do so attract a penalty for the various persons associated with the management.

Here in the instant case, Board of Directors of ACP Ltd. has recommended the dividend in their meeting. Such dividend is not declared in AGM. Further, Board has decided to rescind the decision before the date of Annual General Meeting. Thus, the dividend which is only recommended and not declared does not attract penal provisions.

Therefore, Board of Directors may rescind their decision to recommend dividend.