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TEXT BOOK

SPICER AND PEGLER'S

PRACTICAL AUDITING

by

WALTER W. BIGG, F. C. A.

INDIAN EDITION

by

S. V. GHATALIA, B.COM., F.S.A.A., F.C.A.



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FOREWORD

To practitioners and students alike of accountancy and auditing all over the world and particularly in the Commonwealth countries, Spicer and Pegler's 'Practical Auditing' is a constant companion. There is hardly anyone amongst us who has not studied their works, firstly as students and later on as authoritative references in professional life. The first edition of Spicer and Pegler's 'Practical Auditing' was brought out fifty years ago, and the book is now in its thirteenth edition, and its continuing popularity is in no small measure due to its constant revision. Apart from changes in law which have made these revisions necessary, the art and technique of auditing have also kept on changing. Recent editions have been edited by that respected and well-known author, Walter W. Bigg, who has been the mentor of so many of us.

This work has been edited by my good friend, S. V. Ghatalia, who is well-known in practice as well as in the academic field. He is known to so many of us as the Head of the Department of Accountancy of the Sydenham College of Commerce & Economics and as a teacher and an examiner of various professional bodies and universities. He occupies a unique position of knowing intimately the requirements of the students, teaching profession and the practitioners. Besides all these activities, he was my erstwhile colleague on the Council of the Institute of Chartered Accountants of India.

Mr. Ghatalia has rendered a signal service to the profession as well as to the students by undertaking this work. Hitherto, practitioners and students have had to rely on the English edition for the principles and practices of auditing, but when it came to the application of legal requirements, they had to turn to other works because the law in India differed in so many respects from English law. Although basically our laws have drawn considerable inspiration from those in England, we have to contend with many differences peculiar to our conditions. The accounting requirements as laid down in the (U.K.) Companies Act, 1948 differ from those of our Companies Act, 1956 and as now amended by

the Companies (Amendment) Act, 1960. Banking Companies are governed by the Banking Companies Act, 1949 and Insurance Companies by the Insurance Act, 1938. All these Acts have prescribed forms in which Balance Sheets must be prepared. Forms for Profit & Loss Accounts have also been prescribed in some cases, but as far as ordinary trading and manufacturing companies are concerned, detailed requirements for disclosure are laid down.

The Indian edition has, therefore, dealt with the statutory provisions affecting accounts, while leaving basically intact that part of the book relating to practices and principles as embodied in the original work and its successive revisions. In view of this, the professional accountant and the student are now in the happy position of having to contend with one authoritative work of accepted principles of auditing, adapted to the laws prevailing in India as they affect the work of auditors.

I must congratulate Mr. Ghatalia for having revised this book in so able a manner and thereby perpetuating the great traditions of scholarship which have been associated with the authors and the previous editors of this book. I have during the last several years observed with regret the fall in the standards of professional literature in this country and the absence of professional men with academic interests. The strength of a profession lies in the quality and the mental calibre of its new entrants, and unless proper training and education is provided to such persons, the profession will decline in future. Professional books which are written by men of practical experience are an important tool of education, and Mr. Ghatalia has filled a much felt need.

I have no hesitation in commending this book both to professional accountants as well as to students and wish it the success which it so richly deserves.

Bombay,
New Year's Day, 1962

N. R. MODY

PREFACE TO THE INDIAN EDITION

I DEEM it a privilege to have been called upon to edit Spicer & Pegler's *Practical Auditing*—an acknowledged authority on the subject. By a happy coincidence this Indian Edition is being published in the year which marks the completion of half a century of unrivalled popularity and recognition enjoyed by the British edition. In revising the British edition, I have endeavoured to keep intact the basic scheme and treatment of the original work. This Indian edition contains all the best features of the British edition adapted to Indian law and practice.

The first six chapters have been so revised as to bring the audit procedure in conformity with Indian practices and conditions. Chapter VII to X dealing with 'Audit of a Limited Company' have been completely re-written on the basis of the Companies Act, 1956, after its recent amendment. The impact of the new Companies Act on auditing practice has been thoroughly discussed. With a view to help the students and practitioners, who may get lost in the voluminous and intricate provisions of Company Law, I have included by way of *reference* several sections of the Act. The new Companies Act makes important changes in the provisions affecting accounts and audit, making them more complex. Further, in the context of the new economic set-up of the country, the problems of company audit have assumed new dimensions and acquired greater complexity. All these have added considerably to the burden of the company auditor.

The chapter on 'Divisible Profits' has been completely re-written in the light of recent amendment which now provides more or less a complete formula for ascertaining the divisible profits. The changes in law have thrown overboard many legal decisions and judicial dicta which for the past seventy-five years were regarded with the same sanctity as the Ten Commandments. The ratios of these decisions in the altered context have been discussed in detail.

The auditor's liability in India is further enhanced by the strict rules of professional conduct, so zealously and vigilantly upheld

by the Institute of Chartered Accountants of India. Every auditor while discharging his duties cannot but be aware, all the time, of the rules of professional conduct, any infraction of which could well nigh threaten his right to practice. In view of this, the said rules and the disciplinary cases have been adequately dealt with. A new chapter on Banking and Insurance Companies sets out briefly the relevant provisions affecting their accounts and audit. The audit of Electricity Companies in the light of provisions of Indan Electricity Act, 1910, and Electricity (Supply) Act, 1948, has been discussed in detail in Chapter XIV.

In our country, in certain quarters, there is a misleading impression that the responsibility of an auditor extends to reporting on all the non-compliances of company law. An early pronouncement on the subject by the Institute of Chartered Accountants of India will help to clarify the misapprehension and enable the auditor to concentrate more on the accounting principles and audit procedures—without deflecting his attention from matters which properly fall within his purview; without involving himself in purely legal matters, outside the scope of his work.

In writing this book, I have drawn considerably upon my lecture notes and my experience as a teacher and a professional accountant with a view to ensure that the book will subserve adequately the needs of the students and the practitioners alike.

I acknowledge my debt to Mr. W. W. Bigg, the author of the British edition, who, with characteristic British thoroughness, has meticulously examined the manuscript and made valuable suggestions. However, the responsibility for the new material rests entirely on me. This preface will not be complete without acknowledging my gratitude to Mr. N. R. Mody, a veteran, widely respected and loved in the profession. I feel greatly honoured by his foreword to this book. I am grateful to my colleagues Mr. Manubhai A. Parikh, B.A., LL.B., F.C.A., and Mr. B. F. Pavri, B.COM., A.C.A., for providing the "reader-reaction"and for their valuable comments and suggestions. My special thanks are due to Mr. B. F. Pavri for careful compilation of the Index. M. N. P. Ramanathan, B.SC., and Mr. A. Brito, B.A., B.COM., deserve my thanks for typing the manuscript with speed and accuracy.

I am grateful to the Institute of Chartered Accountants of India and the Institute of Chartered Accountants in England and Wales

for their kind permission to reproduce in this book respetctively, "A Guide to Company Audit" and "Statements on Auditing".

Bombay, S. V. GHATALIA
January 26, 1962

PREFACE TO THE SECOND EDITION

IT IS gratifying to note that the second edition of this book has become necessary so soon after its first publication. When the question of reprint of the first edition came up, it was considered expedient to take this opportunity to bring this book up-to-date. Accordingly, the text has been revised wherever necessary on account of minor amendments to the Companies Act, 1956, rather extensive amendments to Banking Companies Act, 1949 and other changes in the law. Apart from this, the text of the first edition remains substantially the same.

1*st July,* 1963 S. V. G.

ACKNOWLEDGEMENTS

THE publishers wish to express their grateful thanks to Messrs. H.F.L. (Publishers) Ltd., for their kind permission to bring out this Indian Edition of the book.

PREFACE TO THE THIRTEENTH EDITION

SINCE the publication of the last edition the Council of the Institute of Chartered Accountants in England and Wales have made further recommendations on a number of important matters and, where appropriate, these have been included in this new edition. There have also been a number of changes during the last three years in the law relating to the accounts and audit of certain undertakings, e.g., insurance companies and building societies, to which I have had regard in the revision of the chapter dealing with the special points which arise in different classes of audit. I have also taken the opportunity to review the whole of the text in the light of modern practice.

I have again to acknowledge my indebtedness to Mr Ernest Bedford, F.S.A.A., formerly Town Clerk of the Metropolitan Borough of Stoke Newington, for his revision of the chapter dealing with the audit of the accounts of local authorities.

I also have to thank Mr A. E. Langton, LL.B.(LOND.), F.C.A., for the assistance he has given me in the preparation of this edition.

London,
March, 1961

WALTER W. BIGG

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CHAPTER I

THE PRINCIPLES OF AUDITING

§ 1. The Origin of Auditing

The practice of auditing had its origin in the necessity for the institution of some system of check upon persons whose business it was to record the receipt and disbursement of money on behalf of others. In the early stages of civilisation the methods of account were so crude, and the number of transactions to be recorded so small, that each individual was no doubt able to check for himself all his transactions, but as soon as the ancient States and Empires acquired any coherent organisation, records are found of systems of check being applied to their public accounts, the ancient Egyptians, the Greeks, and the Romans, all having utilised systems of check and counter-check as between the various financial officials.

The ancient records of auditing are confined principally to public accounts, but there is clear indication that from an early date it was customary for an audit of the accounts of manors and estates to be performed. The person whose duty it was to make such an examination of accounts became known as the auditor, the word being derived from the Latin *audire*, to hear. Originally the accounting parties were required to attend before the auditor who *heard* their accounts.

It was not until the fifteenth century that the great impetus given to trade and commerce generally by the Renaissance in Italy led to the evolution of a system of accounts which was capable of recording completely all kinds of mercantile transactions, and the principles of double entry were first published in 1494 at Venice by Luca Pacioli, although the system had been more or less utilised during the preceding century. It thus became possible to record not only cash transactions, but all transactions involving matters of account, and the duties of the auditor correspondingly increased.

The increase in volume of trading operations, necessitating the use of more capital than was at the disposal of the average trader,

induced him to combine in partnership with others for the purpose of obtaining the requisite funds, and this tendency was a potent factor in the evolution of a more perfect system of accounts.

In the same way, no doubt, it had a material effect on the practice of auditing, but the audit of business accounts did not become common until the 19th century. The enormous increase in trade in that period, which was fostered by the discovery of steam traction and by mechanical inventions generally, led to the formation of numerous joint stock companies, and other corporate undertakings, involving the use of large sums of capital under the management of a few individuals. Under these conditions the advantages to be obtained from utilising the services of auditors became apparent to the commercial public generally, and a great increase in the practice of auditing resulted; at the present day it forms the most important part of a professional accountant's business.

In India, the growth of the Accounting profession was an outcome of the Indian Companies Act, 1913, which prescribed for the first time the qualifications for an Auditor. Prior to 1913, no qualifications were prescribed.

Initially, the qualification was obtained by passing the examination of the Government Diploma in Accountancy, which was conducted by the Provincial Governments.

Subsequently, an Indian Accountancy Board was established under the Auditors' Certificates Rules, 1932. With the growth of the accountancy profession, there emerged a growing demand for autonomy.

On the passing of the Chartered Accountants Act, 1949, substantially the whole of the regulation, control and management of the profession passed from the Central Government to the profession.

§ 2. The Nature and Definition of an Audit

It has been pointed out that an audit was originally confined to ascertaining whether the accounting party had properly accounted for all receipts and payments on behalf of his principal, and was in fact merely a cash audit; but the object of a modern audit, although it includes the examination of cash transactions, has as its ultimate aim the verification of the financial position

disclosed by the Balance Sheet and the Profit and Loss or Revenue Account of the undertaking.

An audit may, therefore, be said to be such an examination of the books, accounts and vouchers of a business, as will enable the auditor to satisfy himself that the Balance Sheet is properly drawn up, so as to give a true and fair view of the state of the affairs of the business, and whether the Profit and Loss Account gives a true and fair view of the profit or loss for the financial period, according to the best of his information and the explanations given to him and as shown by the books; and if not, in what respects he is not satisfied.

It must not be implied from the above definition that the whole duty of the auditor is to compare the Balance Sheet and Accounts with the books in order to see that they agree therewith. He must do this, but he must also, by the exercise of reasonable skill and diligence, satisfy himself that the books themselves contain a proper record of the transactions entered into, as far as his information and the explanations given to him extend. This will involve a more or less complete examination of the whole of the transactions of the business, and the manner in which they are recorded. How far such an examination must extend will depend upon the individual circumstances of each case, and must be decided by the exercise of the auditor's judgment. It is sufficient here to say that whatever the extent of the examination, it must be such as will satisfy the auditor, having regard to whether he is acting under the direct instructions of his clients or under Statute.

§ 3. The Objects of an Audit

As already stated, the main object of an audit is the *verification* of accounts and statements prepared by a client or his staff. Although of great importance, the detection of fraud and error must be regarded as incidental to such main object.

The prevention of fraud and errors by reason of the deterrent and moral check imposed is also an advantage of considerable importance which is derived from an audit.

(A) The Detection of Fraud

In the minds of the public at large, and of many clients, the

discovery of fraud is the principal function of the auditor, overshadowing his other duties entirely, and although this is far from correct, there can be no question that it is of great importance.

Fraud may be divided broadly into two classes:

(1) Defalcations, involving either misappropriation of money or goods.
(2) The fradulent manipulation of accounts not involving defalcation.

As regards the first class of cases, where accounting parties are not subjected to any form of check, the opportunities of commiting fraud are so frequent, and the methods necessary to conceal it so comparatively simple, that it is safe to say that no business of any size could be carried on under such conditions for very long without the risk of fraud taking place. In small businesses, where the individual proprietor is in touch with the whole of the detail, and is able to supervise it effectually, the possibilities of concealing fraud may be remote. As soon, however, as the business increases and the proprietor is no longer able to do this, if a check is to be maintained at all it must be carried out either by members of the staff themselves or by an independent auditor. Where the staff is sufficiently large to enable the whole of the work to be subdivided, so that the duties of every member of the staff come under the scrutiny of at least one other member who has had no part in the performance of those duties, what is known as an *internal check* comes into operation, and the first business of the auditor should be to examine carefully the system in force, and to ascertain its deficiencies, if any. The strength of a chain is the strength of its weakest link, and the same may be said of a system of internal check.

The auditor, therefore, should pay particular attention to those classes of transactions which offer special facilities for fraud, the principal of which are cash transactions of one kind or another.

As general principles only are under consideration here, the actual way in which these transactions should be verified will be dealt with in due course, but it may be noted that there are two methods by means of which the misappropriation of money may be concealed; the first by the inclusion of fictitious payments; and

the second by the omission of cash received, the latter class being much the more difficult to detect.

The amount of detail checking which the auditor must perform before he can satisfy himself that no fraud exists, will depend to a great extent on the system of internal check in operation. Where that system is good, collusion between two or more persons must have occurred for fraud to remain undetected. Collusion is not infrequent, and cases of it occur from time to time; but, though certain individuals may not themselves be inherently honest, they see the force of the proverb that "honesty is the best policy." Such a person might consider it more to his advantage, when approached by a fellow employee with a view to collusion, to report the matter to his principals than to participate in the fraud, and incur the risk of discovery, with its resulting consequences. The necessity for collusion in order that fraud may be perpetrated and concealed, therefore, is a very great safeguard, and one upon which the auditor is entitled to rely. He must not, of course, do this indiscriminately, and assume that because there is a good system of internal check in operation he need perform no detail checking whatever. Transactions must be tested as exhaustively as the circumstances permit, and should the auditor find anything irregular he must make a complete examination.

The second class of fraud, entailing the falsification of accounts without corresponding defalcations, is naturally considerably less frequent than the class of fraud above-mentioned, but when it does occur it sometimes involves very large amounts. It may be done for the purpose of bolstering up a business which is in an insecure condition, in order to maintain the confidence of shareholders or the public; or it may be done by a manager for the purpose of increasing the apparent profits of the business, thus showing that he has been successful in his management, and possibly increasing the commission on results payable to him; or by directors for the purpose of enabling them to pay dividends which would otherwise not have been possible. Several notable cases of this sort of falsification have occurred. It need only be pointed out here that this form of fraud is often very ingeniously and skilfully concealed, and is in many cases carried out by persons holding positions of the highest trust, and having the entire confidence of directors and shareholders.

(B) THE DETECTION OF ERRORS

An advantage of considerable importance arising from an audit is the *detection of errors.* What appear to be in the first instance merely clerical errors, are sometimes found ultimately to be due to fraudulent manipulation, and it is therefore important for the auditor carefully to examine the cause of any error, however slight it may appear to be. The vast majority of errors, however, are *bona fide,* and due either to carelessness or ignorance.

Errors may be classified under the following headings:

(1) Errors of Omission,

(2) Errors of Commission;

and these again may be classified as

(3) Clerical Errors;

(4) Errors of Principle;

while there is a further type known as

(5) Compensating Errors.

(1) *Errors of Omission*

An *error of omission* arises when any transaction is left either wholly or partially unrecorded in the books. If the former, the omission will not affect the Trial Balance, and will consequently be more difficult to detect. Sometimes it is apparent from the balance of an account that an entry has been omitted; *e.g.,* the Rent Account may show that rent for three quarters only has been paid, and no entry may have been made recording the quarter outstanding. This would become apparent as soon as the item of rent was compared with that of previous years, or the ledger account was examined, but many other cases can be instanced which are much more difficult to deal with; *e.g.,* an item of purchases may be omitted, with the result that the purchases appear as less than they really are, and the creditors are similarly affected. This would not be disclosed by the Trial Balance, but might appear from an examination of the ledger account or the creditor's statement. Where only one aspect of the transaction is recorded, the omission will throw out the Trial Balance. This most frequently arises by reason of items not being posted.

(2) *Errors of Commission*

An *error of commission* arises when a transaction is incorrectly recorded, either wholly or partially. In the former case the Trial Balance may not be affected, but the error should be discovered when the transaction is vouched or otherwise checked; *e.g.*, an entry in a Sales Day Book might be made, and the calculation of the value of the goods incorrectly extended. The posting of the incorrect item would be made to the ledger, and the error would not be discovered until either the calculation was checked or notice received from the customer. If the transaction is partially incorrectly recorded, the result will be to throw the Trial Balance out to that extent; *e.g.*, where an item in the Sales Day Book is posted incorrectly to the ledger.

(3) *Clerical Errors*

A *clerical error* is one occasioned by an incorrect posting; or by posting an item to a wrong account, but one of the same class as that to which it should have been posted; *e.g.*, an item might be posted to the debit of A instead of to the debit of B. If therefore the Trial Balance is agreed, all clerical errors of the first kind should have been discovered, unless they are counter-balanced by other errors. Clerical errors of the second kind, even if undetected, should not affect either the amount of profit or the general correctness of the Balance Sheet.

The following are common instances of clerical errors which the auditor should be on his guard against when engaged on books prior to the Trial Balance being agreed:

(*a*) An item may be posted to the debit instead of to the credit of an account, or *vice versa*. This will throw out the Trial Balance to the extent of *double* the amount in question; *e.g.*, an item of Rs. 30 posted to the debit instead of to the credit will have the effect of making a difference of Rs. 60 on the Trial Balance.

(*b*) An item of Rs. 269 may be posted as Rs. 296. This will make a difference of Rs. 27 in the Trial Balance. This is a very common class of error, and if the difference on the Trial Balance is suscept. of being interpreted in this or a similar manner, all items in respect of which such an error might arise should be re-checked.

(*c*) Although the casts and postings in a ledger account may be correct, the totals of the two sides of the account may not agree, and consequently the balance of the account will be incorrect. In casting ledger accounts and carrying down balances, a junior audit clerk is frequently apt to omit to see that the totals on the two sides of the ledger accounts agree.

(*d*) Errors often arise in carrying forward totals from one page to another; e.g., Rs. 300.10 may be carried forward as Rs. 310.00 or Rs. 189 as Rs. 198.

(4) *Errors of Principle*

An *error of principle* arises by reason of a transaction being recorded in a fundamentally incorrect manner. This is the most important class of error, and one which the auditor should exercise the utmost care to detect.

Minor errors of principle may not affect the ultimate profit, but may arise from revenue items being posted to the wrong class of revenue account; *e.g.*, an item of manufacturing wages posted to Trade Expenses Account, or Balance Sheet items being posted to the wrong class of asset or liability accounts.

Major errors of principle directly affect the profit, and are occasioned by treating a revenue item as an asset or a liability, or *vice versa; e.g.*, treating rent paid as a debtor instead of as an expense.

(5) *Compensating Errors*

A *compensating error* is one which is counter-balanced by another error or errors, so that it is not disclosed by the Trial Balance. This is a dangerous type of error, which is sometimes difficult to detect and it may or may not affect the profit. If the original error and the compensating error both arise in revenue accounts, the profit will not be affected, but if one arises in a revenue account and the other in an asset or liability account, although the Trial Balance will agree, the profit will be incorrectly stated. Such errors arise in various ways, but most frequently in casting; *e.g.*, the cast of an expenditure account may be Rs. 100 too small, and the cast of an asset account Rs. 100 too much, the profit and the assets being thereby increased improperly.

§ 4. Various Classes of Audits, and their Advantages

It may be convenient here to indicate the principal classes of audits which are undertaken in practice, and the advantages to be derived thereform.

(A) AUDITS UNDER STATUTE

Audits are compulsory under Statute in the case of a large number of undertakings, chief amongst which must be placed limited companies. The regulations as to the appointment of auditors and their duties in each of these cases will be dealt with in due course; but the advantages to be derived by the shareholders and proprietors of these concerns, from a professional audit, are similar in their nature, and may be dealt with from the general point of view of limited companies.

It has already been noted that trading partnerships arose by reason of the development of trade requiring the utilisation of more capital than was at the command of the individual trader; and, in the same way, joint stock companies supplied the machinery for utilising, under one management, larger amounts of capital than could be provided by either individuals or partnerships. Such companies operated originally under partnership law, and the liability of each of the members was unlimited. It was impossible, however, to obtain efficient management, and at the same time to permit each individual shareholder or partner to exercise the rights of an ordinary partner, and, as a result, committees of management were formed, in whose hands the whole of the operations of the undertaking were placed. Such persons became known as the directors.

As a result of their position, directors found themselves in a fiduciary relationship to the body of shareholders, and liable to account to them for all their dealings on behalf of the company.

The passing of the Joint Stock Companies Act, 1850, marked the beginning of the institution of Joint Stock Companies in India. In 1857, an Act for incorporation and regulation of Joint Stock Companies and other associations, with or without limited liability, was enacted. The Act of 1860 extended the principle of limited liability to Banking and Insurance Companies. In 1866, the law was consolidated and amended. The Act of 1913 was passed with the object of consolidating and amending the law

relating to trading companies and other associations in British India, as a result of which joint stock enterprise began to grow.

The fact that the whole control of the company was vested in the directors, rendered it necessary that some means should be provided for enabling the shareholders to be assured that the accounts presented to them by the board correctly represented the state of affairs of the company, and that the directors had not utilised their position for the purpose of misappropriating the funds of the company or using them for their private gain. It was impracticable, however, for every individual shareholder to satisfy himself on these points, for as a rule he was not possessed of the requisite technical knowledge, and the right of inspection and inquiry could not be given to one shareholder without being granted to all. Consequently it became usual for shareholders to appoint one or more of their number to act as auditor or auditors of the company, and to report to the shareholders on their examination of the Balance Sheet and accounts. Subsequently it was found inadvisable to confine this function to individual shareholders, who might not be possessed of the requisite qualifications, and it became usual to appoint professional auditors to act on behalf of the shareholders generally. Under the Indian Companies Act, 1913, it became legally necessary for the first time for every limited company to appoint an auditor or auditors. Subsequent amendments to the Act required the maintenance of a register of accountants who were entitled to act as auditors. For this purpose, the Auditors Certificate Rules, were framed in 1932, and the Indian Accountancy Board was constituted. The amending Act of 1936 made extensive changes in the Act of 1913.

With the passing of the Chartered Accountants Act, 1949, the regulation, control and management of the accounting profession was vested in the Institute of Chartered Accountants of India.

The Companies Act, 1956, which replaced the Act of 1913 radically changed the scheme of company legislation in India and, *inter alia,* made vital changes in the provisions relating to the accounts and audit of Joint Stock Companies. Under Section 233A of the amending Act of 1960, power was given for the first time, to the Central Government to direct a special audit in certain cases.

The advantages of a professional audit of a company's accounts

from the point of view of the shareholders are manifold. It has already been pointed out that it is impossible for individual shareholders to be familiar with the details of all the various businesses in which they may be interested as shareholders; moreover, the Articles of companies do not as a rule permit individual shareholders to have access to the books and accounts; and consequently, the shareholders as a body are entirely dependent on the auditor appointed by them, whose duties are to examine the books and accounts of the company, and report to them on every Balance Sheet and Profit and Loss Account laid before the company in general meeting. In addition, the audit acts as a check upon the directors, and as a precaution against fraud on the part of employees. Moreover, the auditor is often able to render valuable assistance, by reason of his expert knowledge of matters of account and finance generally, although it is not within his province to offer advice unless he is asked for it.

In this connection, the functions of an auditor and those of an accountant should be distinguished. It is commonly the custom, particularly with smaller companies, to arrange for the auditor to prepare the final accounts. If he does this, it should be remembered that he acts in the capacity of accountant, under the instructions of the directors, and not in the capacity of auditor appointed by the shareholders.

(B) The Audit of the Accounts of Private Firms

An audit of the accounts of a partnership is, in the interests of the partners, most desirable but such an audit is not required by Statute, although it may be provided for by the partnership agreement or arranged for by mutual agreement between the partners. There are, therefore, essential distinctions between the audit of a company and the audit of a private firm. The former is obligatory under Statute, and the rights and duties of the auditor are defined by Statute; he is appointed by the shareholders, or by the directors on their behalf in certain instances, but they cannot limit his statutory duties, though they can, if they wish, extend them. In the case of a private firm the auditor is not appointed under Statute, but by agreement between the partners, and his rights and duties are defined by them, and can be subjected to modification or limitation.

The auditor of a partnership should study carefully the partnership agreement and particularly note the provisions in the partnership agreement in regard to the following:

1. Capital of the partners;
2. Share of profit or loss of each partner;
3. Interest on Capital Account; Current Accounts; Loans to and from partners;
4. Duration of the partnership;
5. Drawings by partners;
6. Salary and remuneration;
7. Borrowing powers;
8. Accounting year;
9. Nature of business;
10. Restrictions and limitations on the powers of the partners;
11. Basis of valuation of goodwill;
12. Terms as to retirement, dissolution and introduction of a new partner, etc.

Under the Indian Partnership Act, 1932, the important provisions which, apply in the absence of agreement to the contrary, are as under:

1. The partners are entitled to share equally in the profits earned, and shall contribute equally to the losses sustained by the firm;
2. A partner is not entitled to receive remuneration for taking part in the conduct of the business;
3. Where a partner is entitled to interest on the capital subscribed by him such interest shall be payable only out of profits;
4. A partner contributing any moneys beyond the amount of agreed capital is entitled to interest at 6 per cent. per annum;
5. The property of the firm shall be held and used by the partners exclusively for the purposes of the business;
6. The act of a partner in the usual course of business binds the firm.

   Such authority of a partner to bind the firm is called his "implied authority".

In the absence of any usage or custom of trade to the contrary the implied authority of a partner does not empower him to:

(*a*) submit a dispute of the firm to arbitration,
(*b*) open a banking account in his own name,
(*c*) compromise or relinquish any claim or portion of a claim by the firm,
(*d*) withdraw a suit or proceedings filed on behalf of the firm,
(*e*) admit any liability in a suit or proceedings against the firm,
(*f*) acquire immovable property on behalf of the firm,
(*g*) transfer immovable property belonging to the firm, or
(*h*) enter into partnership on behalf of the firm.

7. No person shall be introduced as a partner into a firm without the consent of all the existing partners.

8. In settling the accounts of a firm after dissolution, losses including deficiencies of capital, shall be paid:

(*a*) first out of profits,
(*b*) next out of capital, and,
(*c*) lastly, if necessary, by the partners individually in the proportions in which they were entitled to share profits.

The assets of the firm, including any sums contributed by the partners to make up deficiencies of capital, shall be applied in the following manner and order:—

(i) in paying the debts of the firm to third parties;
(ii) in paying to each partner rateably what is due to him from the firm for advances as distinguished from capital;
(iii) in paying to each partner rateably what is due to him on account of capital; and
(iv) the residue, if any, shall be divided among the partners in the proportions in which they were entitled to share profits.

9. In settling the accounts of a firm after dissolution, the goodwill shall be included in the assets, and it may be sold either separately or along with other property of the

firm.

10. Every partner has a right to have access to and to inspect and copy any of the books of the firm.

11 Where a partner dies or otherwise ceases to be a partner, and if the other partners carry on the business without any final settlement of accounts between them, the outgoing partner is entitled at his option either:

(*a*) to such share of profit attributable to his share in the property of the firm or;

(*b*) to interest at 6% on his share in the property of the firm.

In the case of private firms, the auditor frequently acts also in the capacity of accountant, and although it may be possible for him to distinguish accurately between the work he performs in each of these capacities, the distinction may not be regarded in the same light by his clients. Frequently, where only accountancy work is performed, the client supposes that his books are actually audited, and the responsibility for errors and fraud may in this way recoil upon the accountant. In order to avoid this, the precise duties of the accountant should be carefully defined in writing at the outset, so that no dispute can subsequently arise as to the extent of his responsibility. Similar remarks apply to the professional accountant's work in connection with the accounts of sole traders. This subject is further dealt with in Chapter XII, where legal decisions are considered and the recommendations on the matter by the Institute of Chartered Accountants in England and Wales, are given.

In addition to the advantages common to all forms of audit, *viz.*, the verification of accounts and the detection of errors and fraud, the audit of partnership accounts is advantageous, inasmuch as it affords a convenient means of settling accounts between the partners themselves, and so of avoiding the possibility of future dispute. It is customary to find provisions in partnership agreements arranging for an audit, and making the audited Balance Sheet, when accepted and signed by them, final as between the partners.

The suggestions which the auditor is sometimes able to make with regard to the improvement of the system of accounts in use,

and the expert knowledge of accounts at his command, should also prove of advantage to the business.

The settlement of accounts required on the death or retirement of a partner, or the adjustments arising on the admission of a new partner, are much facilitated when audited accounts form the basis upon which to work; and the same remarks apply to the assessment of the firm for taxation, the necessary adjustments relating to the individual partners, and the preparation of their Income Tax returns. The complexities of taxation law make the advantage of professional assistance in this matter particularly noticeable, since an indifferent knowledge of the procedure may result in considerable loss to the taxpayer.

The sale of the business as a going concern, or the negotiation of loans with banks and others, are considerably facilitated where proper accounts have been prepared and audited.

An audit on behalf of a sleeping partner is very advisable, since such a person, as a rule, has little means of checking the accounts of the business, or of verifying the share of profits due to him.

In the case of individual traders, the arguments in favour of an audit are similar to those set out above, with the exception of the points applicable only to partnerships. In a business of any size, the absence of partners and the impossibility of one man being assured of the correctness of all the details of his business, render it all the more essential that he should employ professional accountants for this purpose.

(c) The Audit of the Accounts of Private Individuals

It is customary for many persons whose incomes are considerable and derived from numerous sources, and whose expenditure is heavy, to have their private accounts audited. Frequently the auditor in such cases also acts as accountant, and actually writes up the books.

The advantages to be derived from an audit of this nature are, in the first place, that the individual is assured of having his accounts properly kept and his expenditure vouched. These considerations apply particularly where the expenditure is incurred in respect of landed property, or the upkeep of large establishments, when it is practically impossible for the proprietor to control personally the payments made. He is obliged to place his

trust in individual agents or servants, and to give them the control of money, and unless an efficient check is exercised over their actions the risk of fraud may be considerable. Secondly, the presentation of accounts prepared on a uniform basis affords a valuable means of comparison of the various classes of expenditure between one year and another, and where such expenditure exceeds the limits of prudence, it is possible immediately to ascertain the origin of the increase, with the result that steps may be taken to rectify the position. The preparation of Income Tax, Wealth Tax, Expenditure Tax and Gift Tax returns etc., is also greatly facilitated.

In addition to the cases above-mentioned, there are many other instances where agents are appointed for the purpose of controlling business operations, and the value of an audit to the principal concerned is particularly apparent when he has no effecitve check on the agent's accounts. Instances of this class of audit are: the audit of the accounts of rent collectors, estate managers, etc.

If private books of account have been kept they will, on the death of the person concerned, be of great assistance to his executors or administrators in their task of preparing the Estate Duty Account. Such books will naturally be of even greater value if their accuracy has been confirmed by a regular audit. As a result of the failure of a person of substance to keep proper records during his lifetime, great difficulty is often experienced on his death in compiling a complete list of all his assets and liabilities.

(D) The Audit of Trust Accounts

The accounts of executors and trustees furnish the occasion for another class of audit.

In the majority of cases executors and trustees are private persons, sometimes possessing considerable business capacity, but sometimes none at all. The law relating to the administration of trusts is very complex, particularly in relation to matters of account. The two classes of beneficiaries—tenants for life and remaindermen, to whom the accuracy of trust accounts is of supreme importance—are often widows and minors, who cannot criticise the accounts in any effective manner. In a great many cases also, the trustees present no accounts at all until forced to do so, and even then such accounts are, sometimes, incorrect. In other

cases the trustees keep no proper accounts, and this omission can serve to conceal misappropriations of trust funds.

For these reasons the advantages of a professional audit of trust accounts, and of a strict verification of the securities composing the trust are apparent. In some of the States in India, Public Trusts Acts have been brought into force, which provide for compulsory audit by qualified auditors. The increasing number of scandals, some of great magnitude, arising from the defalcation of trust moneys, led to the widespread practice of having the accounts of public and private trusts audited by qualified persons.

It may be noted that banking companies, insurance companies, and certain other corporate bodies have taken power to act as executors and trustees, and recognising the advantages of a professional audit to the beneficiaries, they usually arrange that this shall be performed as one of the conditions on which they are prepared to undertake the trust.

Private trustees also recognise the advantages of an audit in their own interest, since any erroneous treatment in the accounts for which they might be personally liable will be pointed out by the auditor, and can then be rectified. Further, they are able to consult the auditor on points of difficulty before action is taken.

§ 5. Audit Procedure

The essential features of an audit can be summarised as under:

1. Examination of the nature, extent and efficacy of the system of internal check and internal control;
2. Ascertaining the arithmetical accuracy of the Books of Accounts by checking postings, castings, cross-castings, carry forwards, opening and closing balances, etc.;
3. Ensuring that the entries have been made and the Profit and Loss Account and Balance Sheet prepared in accordance with well-recognised accounting principles and practice, *e.g.*, the distinction between capital and revenue, accrual system of accounting, valuation principles, etc.;
4. Examining the documentary evidence (internal or external) in support of the transactions, *e.g.*, vouching third party confirmations etc.;

5. Checking the validity of the transactions with reference to:
   (i) provisions affecting the accounts and audit in an Act or Rules;
   (ii) rules and regulations governing the constitution and management of the organisations, *e.g.*, the memorandum and articles of association in the case of a company; the partnership deed in the case of a firm; and the trust deed in the case of a trust;
   (iii) minute books for appropriate sanctions of the transactions by a competent authority;
   (iv) other legal documents such as the prospectus; returns submitted to legal authorities; contracts and agreements *e.g.* vendors' agreement, lease agreement, managing agency agreement, selling agency agreement, technical collaboration agreement, etc.;
6. To see that there is adequate disclosure of information and particulars in the annual accounts in such a manner as to convey the real picture of the net worth and the earning capacity of the undertaking. For this purpose, the auditor must conform to the prescribed legal requirements, if any, as to the form of accounts and should have due regard to the best current accounting practice;
7. Application of various types of overall tests; checks and counter-checks; reconciliation methods; etc., in order to test the integrity of the accounting records;
8. Verification of existence, title and value of the assets and determination of the extent and nature of the liabilities.

§ 6. The Conduct of an Audit

(A) Continuous and Final or Completed Audits

An audit may involve the whole of the transactions in the books being checked, when it is known as a "Complete" Audit; or it may entail checking only some of the transactions, when it is known as a "Partial" Audit. This latter term, however, is incorrect, since any audit worthy of the name must be complete in the sense that the auditor must satisfy himself as to the correctness of the accounts he is asked to verify. In most businesses of any size, however, the amount of detail is so voluminous, and the time occupied in checking the whole of it would be so ex-

cessive, that reliance for the accuracy of the detail, is to a large extent, placed upon the system of internal check in operation in the office itself, and the auditor, after making such tests of the detail work as commend themselves to his judgment, is then able to devote his attention to questions of principle.

In any case, the audit may be carried out either continuously, at fixed or indefinite interim dates, or wholly after the completion of the period under review.

(1) *Continuous Audits*

A continuous audit is one where the auditor's staff is occupied continuously on the accounts the whole year round, or where the auditor attends at intervals, fixed or otherwise, during the currency of the financial year, and performs an interim audit; such audits are adopted where the work involved is considerable, and have many points in their favour, although they are subject to certain disadvantages.

The following are the advantages of a continuous audit:

(1) More detail checking can be performed.
(2) The work is checked sooner than would be the case otherwise; errors can be rectified more quickly; and if any fraud has taken place it is discovered sooner. In the latter event there is less time for the defrauding party to operate, with the result that the amount involved may be considerably less than would have been the case if the audit had not taken place until after the end of the financial period.
(3) The final audit can be completed more quickly, and the accounts presented at the end of the financial year sooner than would otherwise have been possible.
(4) The frequent attendance of the auditor has the effect of causing the staff to keep their work well up to date.
(5) Where the auditor's attendance is at uncertain intervals, the moral check involved is considerably strengthened, as the members of the staff are not aware, from day to day, when the auditor will attend.

The following are the disadvantages of a continuous audit:

(1) It is possible for figures to be altered, either innocently or fraudulently, after the auditor has checked them.
(2) The audit not being carried on consecutively to a finish, it

may be possible for the clerk in charge to lose the thread of the work, and omit to follow up completely transactions which were left open at the date of his last visit.

These disadvantages, however, can be guarded against in order to minimise the risk involved. A strict rule should be instituted, that no alteration may be made in any figures after the auditor has once passed them, and that, if necessary, adjusting entries should be made to rectify any error discovered. The fraudulent alteration of figures is somewhat difficult to provide against, and it is advisable for the auditor to use a special "tick" where he checks figures that have been erased or otherwise altered, and actually to insert (inset on the account or book of prime entry) the figures he has accepted, so that on a subsequent occasion he can see that the amended figures are those previously seen by him.

Fraudulent manipulations in personal accounts can most easily be concealed by making compensating false entries in impersonal accounts. It is of the utmost importance, therefore, in the case of a continuous audit, for the auditor to make certain that no "juggling" can take place with the impersonal accounts which he has already checked; and for this reason, where, as in most cases, the impersonal accounts are not voluminous, it may be wise to postpone checking them until the final Trial Balance has been extracted. The work done during the interim period is usually best confined to the vouching of cash, casting of subsidiary books, and work on the Personal Ledgers, etc.

In some cases it may be inconvenient to leave the impersonal work in this way until the end of the period, and, in that event, unless the Impersonal Ledger is balanced off at the interim periods (which is unusual), the auditor should take a note of all the totals in the Impersonal Ledger up to the date to which he has checked it, and verify these totals on the occasion of his next visit, in order to see that no manipulation has taken place.

The disadvantage arising from the lack of continuity in the work, and the possibility of points being overlooked in consequence, can therefore be remedied by the exercise of proper care and supervision in the conduct of the work, aided by a judicious use of notes.

(2) *Final or Completed Audits*

A final or completed audit is commonly understood to be an audit which is not commenced until after the end of the financial period, and is then carried on until completed. This is the most satisfactory form of audit from the auditor's point of view, and is usually adopted wherever practicable, particularly in the case of small concerns. In large businesses, however, a completed audit is rarely practicable, as the time occupied by the audit after the completion of the accounts would, normally, be so considerable that the presentation of the audited accounts would be delayed beyond a reasonable period.

The proprietors are usually anxious for the audit to be completed as soon as possible after the financial year, and this is very essential in the case of limited companies, in order that annual general meetings may be held and final dividends declared.

(B) CONSIDERATIONS ON THE COMMENCEMENT OF A NEW AUDIT

On undertaking a new audit, the first care of the auditor should be to ascertain the precise nature and scope of his duties. In the case of an audit under Statute, this question does not of course arise, but in other cases the line between accountancy work and audit work proper is sometimes so uncertain, at any rate in the minds of clients, that it is advisable for the auditor to ascertain in the first instance exactly what his client requires, and to take care that this is formulated in writing, especially where the audit is not to be a complete one.

This information having been obtained, the next step should be to ascertain the precise nature of the business carried on, in order to obtain a picture of what the books should contain. The auditor should then make a careful examination of the system of accounting employed. A complete list of all books in use should be obtained, and where there is a definite system of internal check in operation, the auditor should ask for a written statement regarding it.

The names of the principal officials should also be obtained, together with particulars of the work controlled by each, and the scope of their authority.

From a first general examination of the books, in conjunction

with the above information, the auditor will be in a position to formulate the principal lines on which the audit must be conducted, and the direction these will take will be determined by his appraisal of the efficacy or otherwise of the system of internal check.

Taking as an instance the case of a manufacturing business, the special points to which the auditor should direct his attention in this connection are as follows:

(1) The regulations in force relative to the receipt and payment of cash, and the cashier's duties; and particularly whether he is concerned with the writing up of other books of prime entry.
(2) The methods employed in the preparation of the wages sheets, and the manner of payment.
(3) The regulations in force with regard to the passing and checking of invoices and statements.
(4) The method of keeping and controlling the petty cash.
(5) The manner in which the entries in the Personal Ledgers are checked, and the balances agreed; the intervals at which the balancing is effected; and, in the event of each ledger being balanced separately, whether the Total Accounts are kept beyond the control of the ledger clerk concerned.

The opening Balance Sheet will be examined by the auditor, and the whole of the balances comprised in it should be checked in order to make certain that the period now under review commenced with the balances shown therein. If the accounts have been subject to prior audit, the late auditor's report should be seen, as it may contain material information.

In the event of the business concerned being of a technical nature with which the auditor is unfamiliar, he must acquaint himself as far as possible with the technical details. It is clear that no audit can be effective unless the auditor himself grasps the nature and meaning of the transactions recorded, and it is essential, therefore, for him to make himself intimately acquainted with the procedure, by following through representative transactions of each class until he has succeeded in acquiring the necessary knowledge.

Where an auditor is appointed to supersede another auditor, before accepting the appointment enquiry should be made as to the reason for the change, and the retiring auditor should be communicated with to ascertain whether there is any professional reason why the audit should not be accepted.

Special considerations arising on the occasion of the first audit of a limited company will be dealt with in Chapter VII.

(c) AUDIT NOTE BOOKS

There is a certain amount of difference of opinion among practising accountants as to the advantages to be derived from the use of Audit Note Books. In a properly organised office, it is essential that the principals should be perfectly familiar with the work performed on each audit, so that in the event of the clerk in charge being away or leaving the firm, no difficulty need be experienced in carrying on that particular matter.

It is, therefore, desirable that some definite record should be kept of the work performed at each audit. In order to ensure uniformity, and to make certain that all the work is done which should be done, it is advisable to make out a programme of work, and for the clerk responsible for each portion of the work to initial it as it is performed. In this way the progress of the audit can be ascertained immediately by the principal, and in the event of work being left undone, or errors being passed or made, the responsibility can be allocated to the clerk concerned.

On the occasion of the first audit it is not advisable to draw up a hard-and-fast programme, as the work to be done can really only be decided on as the audit proceeds. Careful note should, however, be taken of the work performed; and this will afford material for the preparation of an Audit Programme to be followed in the future.

The principal argument advanced against this procedure is, that by laying down a definite plan of work, the initiative of the clerk in charge is to a large extent stifled, and the audit is apt to become too automatic in its nature. There is no reason, however, why this should be so, as there is nothing to prevent the clerk in charge from making suggestions for amending the programme, and he should be *encouraged* to do so where his experience shows this to be desirable.

As long as the audit is not allowed to become too stereotyped and the programme is changed or revised from time to time according to circumstances, the system suggested has so many advantages that in a practice of any size it can hardly be dispensed with in one form or another. Great care, however, must be taken to ensure that the programme does not become obsolete.

The practice of making notes during the progress of the audit, apart from a record of the work done, should not be extended further than is absolutely necessary. It is infinitely preferable to clear up a query and to get rid of it, than to make a note of it. Those points, however, which cannot immediately be cleared up must be noted, as in the case of missing vouchers, duplicates of which may have to be obtained.

Points of importance also, which require to be remembered from one audit to another, but which are not apparent on the face of the accounts, should be recorded.

On the occasion of the first audit of a business which is of a technical nature, and where special considerations apply, it is very convenient to make explanatory notes of all transactions of technical difficulty, so that these can be referred to by others who may have to take up the work subsequently.

(D) Method of Work

The method of work to be adopted on any audit will naturally vary with the individual training and experience of the auditor, and with the circumstances of each case. There are, however, one or two points which may conveniently be noted here.

Special "ticks" should be adopted for each class transaction checked, and the following are the usual classes of "ticks":—(1) Posting, (2) Casting, (3) Carry Forward, (4) Vouching, (5) Bank Statement, and (6) Contras. The same kind of "tick" is not used by every firm for the same transaction, nor is this perhaps desirable, but a rule should be made in every office that the system of "ticks" adopted must be closely adhered to and not explained to a client's staff. It is usual for the auditor to use some coloured ink, or indelible pencil in order to distinguish his "ticks" from those utilised by the business itself, and usually colours are changed to distinguish periods.

Each section of the work should be completed, as far as prac-

ticable, and cleared definitely to a certain point. The habit of leaving "loose ends," which is a common failing with some audit clerks, is a very dangerous practice, as it may lead to points being ultimately forgotten or overlooked, or even possibly to fraudulent alterations being made. Fraud has been known to occur where the ledger balances had been checked one day and not cast till the next, the schedules having in the meantime been handed back to the ledger clerk, who had taken the opportunity of altering the figures already checked by the auditor. If the casts had been checked in the first instance this could not have occurred.

In the case of continuous audits, the work should only be performed up to a fixed date to which the books have been completed. In no case should pencil figures be accepted. The practice of making pencil entries or casts is extremely undesirable, and the auditor should insist that all such entries are inked in before he commences to work on the books concerned. In checking balances, unless these are brought down in ink, the auditor should require the amount of each balance to be noted at the side of the ledger account in ink, which preferably should be of some other colour than that used in the body of the ledger. If this is not done, the auditor must himself note such balances in ink, in order to avoid the risk of items being inserted afterwards which would affect the balance.

It is not the business of an auditor to balance the books, although he is often requested to do so. If the auditor undertakes this work, he does so in the capacity of accountant, and not of auditor, and it should be subject to a separate arrangement. The question often arises whether it is advisable for the auditor to commence the audit before the books are balanced. Sometimes it is found necessary to do so in order that the audit may be completed within the required period; but it is not desirable, since it increases very materially the risk of passing errors, as the books have not, in the first instance, been subjected to the clerical test provided by the Trial Balance. In the case of many small companies, however, who have no skilled accountant on their staff, the auditor has no alternative but to deal with some accountancy work.

Where necessary, the auditor should make clear to his client the exact nature of the responsibility assumed, having regard to

the nature of the work undertaken.

§ 7. Internal Audits

It has been suggested that the most desirable form of audit is to have an interim or continuous audit performed by one auditor supplemented by a final audit performed by another, but this is normally prohibitive owing to the expense involved. The principle, however, is carried out by many large concerns by means of an internal audit staff.

The members of the internal audit staff, who are employees of the business, devote their time to reviewing the operations and records of the undertaking and in the course of their duties check much of the detail work. Even if an efficient internal audit exists, however, the need for an independent audit by external professional auditors remains, although the amount of detail checking which they must do may be reduced. The notes on the relation of the Internal Audit to the Statutory Audit issued in 1953 by the Council of the Institute of Chartered Accountants in England and Wales are reproduced hereunder.

(1) The expressions "internal audit", "internal control" and "internal check" are often used indiscriminately and it has therefore been considered necessary in paragraphs 2 to 5 below to distinguish internal control and internal check from what is meant in these notes by internal audit, of which a broad description is given in paragraph 6. The expression "statutory audit" is used primarily to mean an audit under the Companies Act, 1948, but most of the notes apply also to audits under other statutes, for example the audit of nationalised undertakings.

Internal control and internal check

(2) Internal control is best regarded as indicating the whole system of controls, financial and otherwise, established by the management in the conduct of a business, including internal check, internal audit and other forms of control.

(3) Internal check is best regarded as indicating the checks on the day-to-day transactions which operate continuously as part of the routine system, whereby the work of one person is proved independently or is complementary to the work of another, the object being the prevention or early detection of errors and fraud. Internal check therefore includes such matters as the allocation of authorities, the division of work, the proper method of recording transactions and the use of independently ascertained totals against

which a large number of individual entries can be proved, such as a sales ledger control account.

(4) The soundness of the system of internal check and the manner in which it is carried out are matters of fundamental importance to the statutory auditor. It has long been recognised that these matters determine to a great extent the amount of examination of detail which the statutory auditor considers it necessary to undertake. The growing practice of having an internal audit has now made it necessary to consider what effect, if any, the work of the internal auditor may have upon the work of the statutory auditor. It is hoped that these notes will be useful as a brief review of the relation between the two audits.

(5) Persons who are engaged exclusively on work which is a necessary part of the internal check are sometimes described as internal auditors. Work of this kind, such as the routine checking of statements before they are sent out to customers, or of creditors' accounts before they are paid, does not constitute internal audit even when carried out by persons who also undertake other duties which can properly be so described. It is desirable to make this clear at the outset, as these notes are not directly concerned with any work which is an integral part of the system of internal check.

Internal audit

(6) An internal audit is a review of operations and records, sometimes continuous, undertaken within a business by specially assigned staff. The scope and objectives of the internal audit vary widely in different businesses and may, particularly in large organisations, extend to many matters which are not directly of an accounting nature. The internal auditor's duties on non-accounting matters would not normally be a matter for consideration by the statutory auditor and they are therefore not considered further in these notes. On accounting matters the main objective of an internal audit is to assure management that the internal check and the accounting system are effective in design and operation. In practice, the internal auditor may often be required to report also on whether the system of accounting and the internal check are economical. Internal audit is part of the whole system of internal control, but is not an integral part of the internal check or the accounting system. Two essential features of an internal audit are that it should operate independently of the internal check and that in no circumstances should it divest anyone of the responsibilities placed upon him.

Field of relationship between statutory and internal auditor

(7) On accounting matters the internal auditor and the statutory auditor operate largely in the same field and they have a common interest in ascertaining that there is:

(*a*) an effective system of internal check to prevent or detect errors and fraud and that it is operating satisfactorily;
(*b*) an adequate accounting system to provide the information necessary for preparing true and fair financial statements.

(8) Although the two forms of audit have a common interest in the important matters mentioned in the preceding paragraph, there are some fundamental differences:

(*a*) *Scope.* The extent of the work undertaken by the internal auditor is determined by the management whereas that of the statutory auditor arises from the responsibilities placed on him by statute.
(*b*) *Approach.* The internal auditor's approach is with a view to ensuring that the accounting system is efficient, so that the accounting information presented to management throughout the period is accurate and discloses material facts. The statutory auditor's approach, however, is governed by his duty to satisfy himself that the accounts to be presented to the shareholders show a true and fair view of the profit or loss for the financial period and of the state of the company's affairs at the end of that period.
(*c*) *Responsibility.* The internal auditor's responsibility is to the management, whereas the statutory auditor is responsible directly to the shareholders. It follows that the internal auditor, being a servant of the company, does not have the independence of status which the statutory auditor possesses.

(9) Notwithstanding these important differences, the work of both the internal auditor and the statutory auditor, on accounting matters, is carried out largely by similar means, such as:

(*a*) examination of the system of internal check, for both soundness in principle and effectiveness in operation.
(*b*) examination and checking of accounting records and statements.
(*c*) verification of assets and liabilities.
(*d*) observation, enquiry, the making of statistical comparisons and such other measures as may be judged necessary.

Co-operation between statutory and internal auditor

(10) It will be evident from the preceding paragraph that the similarity between the means by which the statutory auditor and the internal auditor carry out their respective duties is such that without co-operation between them there could be unnecessary duplication of work.

(11) Because of his experience acquired in public practice, the statutory auditor may be of assistance in an advisory capacity in connection with the installation and subsequent operation of an internal audit; and in carrying out his duties he may derive much assistance from the internal auditor's intimate knowledge of the accounting system and technical knowledge of the business, particularly in connection with stock-in-trade, the physical existence of fixed assets, depreciation charges, the ascertainment of liabilities and the risks of fraud or misappropriation.

(12) There also exists considerable scope for mutual assistance between the two auditors in the planning of their respective audits. Where the statutory auditor is satisfied that the internal auditor has adequately covered part of the work which the statutory auditor would otherwise do, he may be able to reduce the extent of his examination of detail; and consultation between the two auditors may enable the internal auditor to refrain from carrying out work which he would otherwise do but which, having regard to the examination which the statutory auditor considers he must make in any event would result in duplication. Examples of specific ways in which the work of the two auditors may be co-ordinated are:

(*a*) The statutory auditor may be able to rely to a large extent on the internal auditor in determining whether the system of internal check is operating satisfactorily and in assessing the general reliability of the accounting records.

(*b*) The programme of the internal auditor may include, by agreement, work which has the effect of giving direct assistance to the statutory auditor by participating during the accounting period in matters such as cash counts and visits to branches, made either by the internal auditor alone or jointly with the statutory auditor.

(*c*) The internal auditor may arrange his programme at the end of the accounting period so that assistance is given to the statutory auditor in connection with matters such as the confirmation of customers' accounts, verification of assets such as stock-in-trade and the preparation of audit working schedules required by the statutory auditor for his records.

(13) The internal auditor's responsibility is to the management and he is in no sense a servant of the statutory auditor. It follows therefore that the extent to which the internal auditor can so arrange his work as to be of specific assistance to the statutory auditor will depend upon decisions of the management on the scope of the internal audit and the number of staff employed thereon. Consultation between the two auditors, and where necessary with the management, should however ensure that so

far as is practicable the fullest possible assistance is available to the statutory auditor.

(14) It is for the statutory auditor to decide whether and to what extent, consistently with his statutory responsibilities, he can rely on the work of the internal auditor in order to reduce the extent of his own examination of detail. His decision will depend upon his judgment on the facts of each case, having regard in particular to:

(*a*) The extent and efficiency of the internal audit. In order to assess these matters the statutory auditor should examine the internal audit programmes, working papers and reports and should make such tests as he thinks fit of the work done by the internal auditor.
(*b*) The experience and qualifications of the chief internal auditor and his staff and the character of their reports.
(*c*) The authority vested in the chief internal auditor and the level of management to which he is directly responsible.

The statutory auditor cannot in any circumstances divest himself of the responsibilities laid on him by statute.

§ 8. The Qualities required of an Auditor

The general principles of auditing having been indicated, it may be profitable to point out the essential characteristics which an auditor must possess if he is to perform his duties efficiently.

In the first instance it is imperative that the auditor should have a wide knowledge of the theory and practice of accountancy, and should be so familiar with the underlying principles thereof, that he can apply them without difficulty to transactions of which he has had no previous experience. It is impossible for a person to audit accounts properly unless he is capable of preparing those accounts himself. The lack of this fundamental requirement is the principal cause of inefficient auditing, and it cannot be too strongly emphasised, that the only safe rule to adopt is never to pass a transaction if its precise meaning is not understood. Unfortunately this principle is often transgressed by those who, not having the requisite experience or knowledge, are afraid to ask the necessary questions, and consequently pass items blindly, trusting to luck that they are in order. Such a habit—for it is apt to become a habit—involves very heavy risks, and is certain to end sooner or later in disaster. It is impossible for everyone

to have experience in every class of business, and occasions must from time to time arise when the auditor is presented with transactions of a technical nature, of which he has no knowledge.

The proper course for the auditor to pursue in such circumstances is to ask intelligent questions of his clients or their staff, and thus place himself in possession of the requisite information to enable him to criticise the transaction. The exercise of a certain amount of tact is required, and considerable caution is needed to avoid putting questions which, owing to ignorance of technicalities, would appear ridiculous; but, assuming this to be done, greater respect will be gained by an honest admission of unfamiliarity with the transaction, than by the assumption of knowledge which is not possessed, and the lack of which will be almost certainly discovered.

Lord Justice Lindley said: "An auditor must be honest—that is, he must not certify what he does not believe to be true and he must take reasonable care and skill before he believes that what he certifies is true." (*In re London and General Bank* (*No.* 2), 1895 2 Ch. 682).

If there is a difference of opinion between the auditor and his clients on a matter of importance, he must have the courage of his convictions. He must possess, in some considerable degree, that characteristic of genius—an infinite capacity for taking pains; he should possess tact and patience; he must be conscientious, and must not be hurried into signing a certificate or report until he has received the whole of the evidence which he requires, or sign under a promise that evidence required will be forthcoming the next day.

An auditor must exercise constant vigilance; he must not allow his work to become automatic, or to lapse into a mechanical routine. He must be accurate, since his function is to detect the mistakes of others; he must be methodical, in order that no detail of his work may be omitted; he must be cautious, but he need not be unduly suspicious. As Lord Justice Lopes said: "An auditor is not bound to be a detective or, as was said, to approach his work with suspicion, or with the foregone conclusion that there is something wrong" (*In re Kingston Cotton Mill Co.* (No. 2), 1896 2 Ch. 279), and he must never relax his high standard.—"If an auditor has, even in one instance, fallen short of the strict

duty of an auditor, he cannot, I apprehend, be excused merely because in general he has displayed the highest degree of care and skill" (per Romer, J., *In re The City Equitable Fire Insurance Co., Ltd.*, 1924, Acct. L.R. 53 and 81).

If asked to give advice on matters of financial policy, or to suggest improvements in the accounts, an auditor must be prudent, and above all things practical. Theoretical knowledge can often be pushed to excessive extremes, and it must be tempered with a nice appreciation of practical possibilities.

Last, but not least, the auditor should have a full share of that most valuable commodity—common sense.

CHAPTER II

THE AUDIT OF CASH TRANSACTIONS

§ 1. Internal Check as regards Cash

BEFORE commencing the audit of the cash transactions of a business, it is most important that the auditor should make himself familiar with the system of internal check in operation under this heading, since the majority of frauds arise directly in connection with cash.

A system of internal check is an arrangement of staff duties whereby no one person is allowed to carry through and to record every aspect of a transaction, so that, without collusion between two or more persons, fraud is prevented and at the same time the possibilities of error are reduced to a minimum.

It is not intended to set out here any complete system of internal check as regards cash, but merely to indicate the main points to which an auditor should direct his attention.

The duties of the cashier must be ascertained, particularly as to whether he has charge of any ledgers or books of prime entry other than the Cash Book. In large businesses, the cashier will be fully employed with his proper duties, but in smaller concerns it is not usually found possible to occupy the whole of one man's time in the performance of the duties of a cashier. In such cases, the opportunities for the concealment of fraud by the cashier are considerably enlarged.

(A) RECEIPTS

The method of dealing with money received should be ascertained, and particular reference made to the following points:

(1) Whose duty it is to open letters containing remittances?
(2) Whether all remittances are immediately crossed, by means of a rubber stamp, to the firm's bankers, and for the firm's account?
(3) Whether the remittances are entered in a rough Cash Book

or Diary, and checked and initialled by at least two persons, neither of whom is the cashier; and whether the daily totals of such a Diary are subsequently compared with the entries in the Cash Book, and if so, by whom?

(4) Where printed and numbered receipts are issued, these should not be prepared by anyone connected with entering remittances in the rough Cash Book or Diary. Unused receipt books should be kept in safe custody.

(5) Whose duty it is to enter up the counterfoil of the paying-in book? The cashier should enter up the slip to be retained by the bank, while the clerk who makes out the counterfoil receipts should enter up the counterfoil portion of the paying-in book.

(6) Whether all receipts are banked daily, and whether or not the clerk, whose duty it is to take money to the bank, is otherwise engaged in connection with the cash transactions?

(7) As to the method of recording and checking cash sales (if any).

(8) Whether there is any authority for travellers to collect debts, and under what conditions?

(9) As to the frequency with which the bank statement is checked with the Cash Book, and reconciliation statements prepared, and whether this is done by anyone other than the cashier?

(10) As to the custody and treatment of any bills receivable.

(B) PAYMENTS

The auditor's attention should be directed to the following points:

(1) Whether all payments are made by cheque, with the exception of those dealt with through petty cash; who has authority to sign cheques, and whether any counter-signature is required?

(2) Whether cheques are made payable to "Bearer" or "Order," and whether they are crossed "A/c Payee only —Not Negotiable" before being sent out?

(3) Whether proper regulations are in force for checking state-

ments with invoices before cheques are drawn, and for invoices to be stamped 'paid' when the cheques are signed?

(4) Whether the paid cheques are filed in numerical order after they are received back from the bank or attached to the relative invoices or statement.

(5) What regulations are in force to sanction payments of a special nature? This authority should be exercised only by principals or directors.

(6) What system is in operation as regards petty cash?

(7) What system is in operation as regards the preparation and payment of wages?

§ 2. Vouching Payments

(A) General Considerations

While vouching payments the auditor should examine the evidence of the payments being received by the proper party. The evidence usually will consist of the payee's receipt normally on his own form.

It should be noted that when the receipt is for an amount exceeding Rs. 20 a stamp for ten naye paise should be fixed thereto according to the requirements of the Indian Stamp Act, 1899 (which makes provisions for the stamping of various documents). Clause 23 of Section 2 of the said Act defines a receipt as follows:—

"Receipt" includes any note, memorandum or writing:—

(*a*) whereby any money or any bill of exchange, cheque or promissory note is acknowledged to have been received, or

(*b*) whereby any other movable property is acknowledged to have been received in satisfaction of a debt, or

(*c*) whereby any debt or demand, or any part of a debt or demand, is acknowledged to have been satisfied or discharged, or

(*d*) which signifies or imports any such acknowledgement, and whether the same is or is not signed with the name of any person.

Section 3 of the said Act provides that an instrument shall be chargeable with the duty indicated in Schedule I, item No. 53 of which prescribes that Stamp Duty for receipts in respect of amounts exceeding Rs. 20 shall be ten naye paise. The said item also prescribes certain exemptions which include, *inter alia,* receipts executed on behalf of the Government and receipts for any payment of money without consideration (It also confers exemption on Co-operative Societies).

In respect of receipts for payments made in foreign countries, the law of the land where the payment is made will apply.

In India, some of the big concerns, by arrangement with the banks, use cheque forms specially printed with their own name, and containing on the back a suitable form of receipt. Completion of the receipt also serves as an endorsement of the cheque. The discharged cheques are returned by the bankers to the clients, and constitute vouchers for the payments.

Where payments for goods or services supplied are debited to a personal account of the supplier, the auditor's only interest in such payments lies in ensuring that the supplier did, in fact, receive the amount of the remittance, because the transaction in respect of which the payment arises will have been recorded in some book of prime entry or its equivalent, which he will vouch in the course of his audit. If all cheques issued by the firm are crossed "not negotiable, account payee only" the recipients of such cheques cannot negotiate them to third parties and the receipted cheques can, therefore, be accepted by the auditor as evidence that the payments have been made to the persons named. Where, however, cheques are not crossed "account payee only" and can, therefore, be negotiated by the payee to the third parties, it may be necessary to ascertain that the receipt is executed by the party to whom the payment is purported to be made and in case of doubt the auditor should call for other supporting evidence *e.g.,* a statement of account.

In recent years, many firms have discontinued the use of Bought Ledgers and Bought Day Books in order to reduce clerical labour. In such cases, all invoices from suppliers for goods or services are filed until payment is due, so that no accounting entries in respect thereof are made until cheques in settlement are drawn and entered in appropriate columns in analysed or special

Cash Payments Books. In these circumstances, the auditor has a two-fold duty in respect of payments made, *viz.*,

(*a*) to verify the consideration for which each cheque has been drawn, and
(*b*) to see evidence that the proceeds of the cheques have been received by the payees thereof.

Under these conditions, the auditor's work will be greatly facilitated if the receipts are attached to the invoices or statements to which the payments relate.

The auditor should always insist on the production of specific receipts for payments of an exceptional nature, *e.g.*, loans, settlements of claims, disputed accounts, etc., and where, in his view, it is essential that the payment made be linked with or appropriated to some specific transaction.

Where receipted cheques are accepted as evidence of payment, the auditor should take care to see that the names of the payees and the dates on the cheques agree with the names and dates in the cash book.

If at the same time as he vouches the payments it is necessary for the auditor to verify the nature of the consideration therefor, by reference to invoices, etc., he should pay particular attention to the following points when examining the relevant vouchers:

(1) The name of the party to whom the voucher is addressed.
(2) The date of the invoice or statement.
(3) The nature of the payment.
(4) Whether the payment has been passed as in order and by whom?
(5) The account to which the item is posted.

It is important for the auditor to observe the name of the party to whom the voucher is addressed. The fact of its being addressed directly to the business concerned is *prima facie* evidence that the payment relates to the business, but in some cases it may be found that vouchers are addressed to an individual, such as a partner, director, or manager. When this is so, care must be taken to ascertain that the payment is a proper business one, and

the auditor should make certain of this by referring to the original invoice to which the payment relates, and seeing that the goods are of such a kind as would be required by the business; also it might be advisable to refer to the Goods Received Book or the suppliers' advice notes, to see that the goods have actually been received by the business. If the payment does not relate to goods, it is still more necessary for the auditor to make sure that it is actually connected with the business, and he will do this by examining whatever evidence is available. If, however, there are any items properly chargeable to individuals, the auditor should ascertain that such payments are debited to the personal accounts concerned.

The auditor will have ascertained whether there is an efficient system of internal check as regards the examination and checking of invoices and statements for payment, and he should also ascertain the names of the parties whose duty it is to perform this work, and to initial the documents as having been checked. In examining the vouchers, therefore, it should be seen that the items have been properly checked and initialled by the parties responsible, and particular care should be taken, where the payment is of a special nature, to see that it is duly authorised.

After each voucher has been passed by the auditor he should cancel it, preferably by the use of a rubber stamp bearing the name or initials of his firm, in order to prevent the same voucher being produced on a subsequent occasion in support of another transaction.

It will be appreciated that the foregoing remarks regarding receipts apply only to payments made by cheque. The auditor must inspect proper receipts for all payments made in cash and when doing so he must pay particular attention to the following matters in addition to those referred to above in connection with invoices and other documents supporting cheque payments:

(*a*) The date on the receipt and whether it is properly stamped.
(*b*) If the statement states that only the firm's official receipts will be recognised, that the official form has been used.
(*c*) That the figures on the receipt do not appear to have been altered.

Cash discount allowed by trade creditors is usually entered in

a special column on the credit side of the Cash Book reserved for discount, the entry being made opposite the payment to which it relates. The auditor should question any apparent failure of his client to take advantage of discounts available to him—the gross sum may have been paid and the discount shared with an employee of the payee.

The discount column should be cast, and the total checked to the credit of Discount Receiveable Account.

(B) MISSING VOUCHERS

As soon as the auditor has completed his examination of the vouchers, he should extract a list of items which remain unvouched, and, where necessary, ask for duplicates to be obtained.

Vouchers for certain items will not be found in the ordinary voucher file, but the payment can be verified by reference to other books and documents.

(C) CAPITAL EXPENDITURE

The vouching of payments made on account of capital, and posted direct from the Cash Book to the asset account, is of great importance, since any erroneous treatment may affect the amount of profit or loss.

The subject of the distinction between capital and revenue expenditure demands separate treatment, and it is only proposed to deal here with the vouching of cash payments on capital account, and to indicate the procedure to be adopted in dealing with the usual classes of payments of this nature.

(1) *Freehold and Leasehold Property*

The completion statement from the firm's solicitors must be examined. This statement will show the amount payable for the property, the amount of the deposit paid and the apportionments between the vendor and purchaser of rates, taxes, insurance etc. Legal charges and stamp duties payable may also be embodied in this statement but, if not, will be the subject of a separate account from the solicitors. The auditor must take care to see that the apportionments of rates, etc., have been correctly charged or credited to the appropriate impersonal accounts and not included in the debit to the asset account. The legal costs and

stamp duties incurred on the acquisition of capital assets may properly be regarded as part of their cost.

(2) *Buildings*

Where the building is being erected under contract, the actual contract should be examined and also the accounts for extras, if any. Payments under the contract will usually be made on a surveyor's certificate, and this should be seen by the auditor, in addition to the paid cheque or receipt given by the builder. The surveyor's fees should be vouched by reference to his account; such items form part of the cost of building and can be charged to capital. In certain cases, the buildings may be wholly or partially erected by the staff of the business, in which event allocation of materials and wages will be necessary. Such division, however, will not usually be made through the Cash Book, but will be dealt with through the Journal and the vouching of such allocation will consequently arise in connection with that book. In some instances, however, cash purchases may be debited direct to the asset account, and the auditor will then examine the invoices, in order to ascertain that the items are of a capital nature, and to see that they have been properly examined and passed by an authorized person.

(3) *Plant and Machinery*

Similar considerations apply here as in the case of buildings, and all cash payments debited direct to the Plant Account will be examined in the same manner. Care must be taken to see that the expenditure is properly chargeable to capital.

(4) *Patents*

The certificate for the patent should be examined. If the patent has been purchased, the assignment should also be seen, together with the receipt for the purchase consideration. Patent agents' fees in connection with the acquisition can be charged to capital, and will be vouched by production of the agent's account. Fees for renewal of patents must not be charged to the Patent Account, as they represent revenue expenditure.

(5) *Payments under Hire-Purchase and Instalment Agreements*

The actual hire-purchase agreement, or agreement to pay by instalments, should be examined, and the vouchers for the payment of instalments seen. As each instalment will include the proportion of interest which should be charged to revenue, care must be taken to see that the interest is not debited to the asset account, or, if this is done in the first instance, that it is afterwards transferred to Profit and Loss Account. If the amount of the interest is not shown on the statements rendered by the vendors the rate of interest should be ascertained, and the appropriate adjustment made.

(6) *Investments*

For the purchase of investments the brokers' bought note will be examined. The proper vouching of the item will also include the inspection of the securities; but this is not usually done in the course of vouching the Cash Book. It will be dealt with when the verification of assets is considered.

(7) *Loans*

The receipt from the borrower should be inspected. If the loan is secured by mortgage, the mortgage deed will state the amount of the loan, and should be examined, together with the title deeds. It should be seen that there is proper authority for the loan.

(8) *Office Furniture, Fixtures and Fittings*

Similar considerations apply as in the case of plant and machinery, and all cash payments debited direct to the Furniture Account will be examined in the same manner.

Where the fixtures form landlord's fixtures, this fact should be considered in providing the necessary amount of depreciation.

(D) SPECIAL PAYMENTS

Certain payments found in most classes of business are subject to special considerations in vouching, and the more important of these are dealt with below. Special payments, particularly those relating to companies, will be considered in Chapter VII.

(1) *Agents' and Travellers' Commission*

The agreements should be examined to ascertain the actual basis on which the commission is to be calculated and the arrangements, if any, regarding expenses. For payments made to the travellers, receipts signed by them should be inspected. The commission records should be examined and the calculations tested.

(2) *Travelling Expenses*

Travellers' expenses, when payable by the business, are frequently computed on some fixed basis, and when this is the case, it should be seen that this is not exceeded. In other cases, the voucher for travelling expenses should specify the details of the expenditure and the auditor should ascertain that the amount has been passed as in order by a responsible official.

(3) *Insurance Premiums*

The Insurance Company's receipts or receipted cheques will provide evidence for such payments. In the case of first premiums, where interim receipts have not been issued, the auditor should examine the policies, which will contain a note of the premium paid.

(4) *Bank Charges*

Bank charges for commission, cheque books, interest on overdrafts and loans, etc., should be vouched by inspection of the bank statement, and where necessary the calculations should be checked.

(5) *Salaries*

Salaries Books should be in use, containing particulars of weekly and monthly salaries. These should be cast by the auditor, and cheques drawn for salaries vouched therewith. Any changes in the salary list should be verified. The Employees' State Insurance records should be tested with the entries in the Salaries Books. Wages are dealt with separately in § 3.

(6) *Petty Cash*

Cheques drawn on account of petty cash should be vouched by

ascertaining that they are properly entered on the receipts side of the Petty Cash Book, care being taken to see that the dates correspond. The vouching of the Petty Cash Book itself is dealt with in § 7.

(7) *Bills Payable*

The returned bills, duly cancelled, will be in evidence as vouchers.

(8) *Bills Receivable Dishonoured*

If a bill receivable has been discounted through the bank, but is dishonoured on presentation, the amount of the bill will appear as a payment in the bank statement, and will also be entered in the Cash Book, being posted therefrom to the debit of the person from whom the bill was received.

Where the bill has not been discounted, but has been deposited with the bank for collection, it is common to find the amount thereof credited by the bank on the date it becomes due, it being subsequently debited if the bill is dishonoured.

The auditor should examine the dishonoured bill, if it has not since been met or retired. The expenses of noting will appear in the bank statement (in cases where the bill has been presented through the bank), and should be debited to the person from whom the bill was received.

The expenses of discounting a bill will be vouched with the bank statement, if the bill has been discounted with the bank, and should be charged to the Discount Account. In vouching the charge for discount it should be remembered that it is based on the nominal amount of the bill, and not on the money advanced by the bank. Thus the real interest charged is at a higher rate than would appear from the discount quotation.

(9) *Freight and Carriage*

Freight and carriage accounts require careful examination. Where the accounts are voluminous, payments are sometimes made on account throughout the month, and a final statement rendered. Such statement should be checked with the carriage accounts, and the payments on account vouched thereto, thus ensuring that all such payments have been brought into account.

Rebates are allowed by shipping companies in some cases. The auditor should ascertain whether such rebates have been allowed and see that the actual cash payment made corresponds with the net amount payable.

(10) *Customs Duties*

Where customs duties are paid by a railway or forwarding agent on behalf of a customer, they will render monthly accounts which should be examined by the auditor. Where the transactions are numerous, such accounts will follow the same principle as the freight accounts above mentioned.

The customs duties may be paid either in cash or through a Current Account maintained with the Customs authorities. The cash payment should be vouched with reference to the receipts issued by the Customs authorities. If a Current Account is maintained the entries in the Pass-book or Statement should be compared with the entries in the books of accounts and further, the payment can be checked with the advice issued by the Customs authorities.

In respect of Customs Duty, if there is any dispute or a refund is claimable, it should be seen that the refunds are recovered and that any outstanding refunds are adjusted at the end of the year.

As the sums involved are sometimes very large, and special opportunities exist for fraud in connection therewith, the auditor should vouch the Duty Account thoroughly.

(11) *Income Tax and Sales Tax*

Income Tax may become payable either on regular assessment under Section 143, provisional assessment under Section 141 or in advance under Section 207 of the Income Tax Act, 1961. The tax payable on regular assessments should be checked with reference to the receipted challan, notice of demand, assessment order and assessment form. For the provisional assessments and advance payment of tax the evidence will be the relevant notices of demand and receipted challans. Interest credited on advance payment of tax and penal interest under Sections 214 and 215 should be adjusted on Interest Account.

Income Tax deducted under Section 192 from the employees salaries and wages must be paid over monthly and the official

receipts should be seen. The auditor should also check the amount of the remittance with the total of the deductions during the month in question. The total amount deducted during the year can be further checked with the Annual Return under Section 206.

In respect of Sales Tax, Central or State, the client will be collecting Sales Tax on behalf of the State or the Central Government as the case may be. The payments of Sales Tax must be checked with the receipted challans and the quarterly returns submitted to the relevant Sales Tax authorities. Ultimately, if on assessment it is found that the tax collected is short, it will usually, be borne by the client himself and written off to the Profit and Loss Account.

(12) *Partners' Drawings*

In respect of partners' drawings, the receipt from the partner or a confirmation of each amount should be examined to ensure that the sum was in fact received by the partner concerned. Where payments are made to third parties on behalf of partners, it is not always possible to obtain receipts, and such items should be vouched by direct reference to the partner concerned. Where partners' drawings are numerous, each partner should be asked to initial his Drawings Account as being correct.

§ 3. Wages

(A) Internal Check as Regards Wages

The vouching of wages is a very important part of the auditor's duties in the case of a concern employing a considerable number of workers, owing to the possibilities of fraud in this direction. It may be said that no auditor can vouch this item satisfactorily unless there is a proper system in force as regards the preparation of the wages sheets and the payment of the workers. The first care of the auditor, therefore, will be to examine the methods adopted, and if he finds that the internal check in this connection is inadequate, he should advise his clients of the risks likely to result from this fact and suggest to them the alterations he considers to be advisable. Should his recommendations not be adopted, the auditor would be wise to disclaim any responsibility for

errors or fraud which can be attributed to the lack of system, in order to protect himself from any subsequent charge of negligence.

The best system to be adopted in any particular case will naturally vary with the circumstances, but the principal dangers which any system should be designed to counteract are as follows:

(1) Inadequate time records, resulting in workers receiving pay for time not devoted to the business.
(2) Inadequate piece-work records, enabling pay to be received for work not executed.
(3) Errors in the preparation of the wages sheets.
(4) Fraudulent manipulation of the wages sheets, enabling cash to be drawn in excess of amounts due, or fictitious names to be inserted.

In order to counteract these dangers, a system should be in operation which will necessitate collusion between two or more officials before any fraud can remain undetected for any length of time. It is essential that any such system should be strictly adhered to, and supervised by those responsible for the control of the business, who should at all times be prepared to introduce such variation as experience proves to be advisable.

The following is an outline of a system of preparing wages sheets and paying the wages, which, if properly carried out, should effectually minimise the risk of fraud.

(1) There should be a properly organised wages office under the control of a responsible person who should not be the cashier.
(2) A record card showing, *e.g.*, date of birth, marital status, terms of employment, name of previous employer, etc., should be kept for each worker.
(3) Rates of pay and alterations thereto should be set out in writing and duly authorised.
(4) The times of workers entering or leaving the works should be recorded, either by a gatekeeper or time-recording clock. In order to avoid loitering in the works, and to act as a check

on the original record, the foreman of each department should take the times of the workers entering and leaving the shops, or departmental time clocks should be utilised.

(5) Where pay is based on the actual work performed, and not on the time occupied, an efficient system of recording piece-work is essential. When the work is given out it should be entered on the piece-worker's card. On completion, this card should be initialled by the piece-work viewer as soon as the work has been examined and checked by him, and where possible, also by the stock-keeper.

(6) Overtime should be separately recorded and passed by the foreman and by the works manager.

(7) Separate wages sheets or books should be used for time-workers and piece-workers respectively, and should be ruled to record all the essential particulars, special columns being provided for the gross amount payable, deductions for Employees' State Insurance, Provident Fund Contribution, Income Tax, Loans, Fines, etc., payments on account, and the net amount payable. Columns should also be provided showing the employer's contributions under the Employees' State Insurance Act.

The gate records and departmental time records should be compared by two clerks in the wages office, and any discrepancies enquired into. Another clerk should enter on the wages sheets the names of the employees, rates of pay, number of hours worked, and particulars of any deductions. A separate clerk should work out and enter up the net amount due to each worker, and cast the sheets, the calculations being checked by another clerk. Similar work should be performed in connection with the piece-workers' wages. Each clerk responsible for the preparation of the sheets should initial for that portion of the work performed by him, and the whole should be countersigned by the works manager, a partner, or a director.

(8) Wages should be paid by a person or persons, who have not performed any part of the work detailed above. An analysis of the wage payments should be prepared so that the proper amount of change can be obtained from the bank. A separate cheque should then be drawn for the precise amount of

the wages, and each person's wages placed in an envelope endorsed with details showing the make-up of the contents. Preferably, the Employees' State Insurance Stamps should also be paid for by a separate cheque. The workers should attend personally to receive their wages, the foreman of each department being present when the workers in his shop are being paid, in order to avoid the possibility of substitution. Special arrangements should be made for the payment of wages of workers who are absent, and the wages of one person should only be paid on his behalf to another on production of written authority from the absentee.

As a general rule it is not found possible to obtain the signature of each worker for wages, and where such a system as the above is in force, it is not necessary to do so. The payment should be attested by the signatures of the person who has made the payment, the foreman, and the works manager, if present.

The occasional attendance of a partner or director whilst the workers are being paid also adds considerably to the check imposed.

(B) The Auditor's Duty as Regards Wages

The auditor will ascertain precise particulars of the methods employed in preparing and paying wages, and will pay special attention to any portion of the system which he considers to be defective. Where such a system as the one described above is in force, the auditor will ascertain that it is regularly and properly carried out, and that the signatures and initials of those responsible are duly appended to the wages sheets. He will vouch the cheques drawn for wages and insurance with the totals shown by the sheets, and check the casts and extensions of a certain proportion of the items. The Employees' State Insurance and Income Tax deduction cards or records should be called for and extensively tested with the names and particulars appearing in the wages sheets. This precaution should minimise the possibility of fraud by the inclusion of "dummy" names in the wages sheets. If adhesive stamps are used the auditor must take care to see that the Employees' State Insurance Cards are stamped up to date or where this is not so, that the stamps or cash drawn for

this purpose are in hand. It is a good plan for the auditor to attend personally on occasions, without notice, at the time of payment of wages.

§ 4. Vouching Cash Received

(A) General Considerations

From the auditor's point of view the operation of vouching receipts is more difficult than that of vouching payments, since only indirect evidence can as a rule be obtained.

The system of internal check should be carefully enquired into by the auditor, and he should direct special attention to any part he considers inadequate. In order to ascertain that the system is properly carried out, he should test each portion of the check in operation, and if discrepancies are found he should carry his examination further. If the transactions he has examined are in order, he is entitled to assume that the remainder can be safely passed. Where a rough Cash Book or Cash Diary is kept, such a book should be tested exhaustively with the Cash Book proper, since, if amounts received are entered in the former but misappropriated by the cashier, and not entered in the Cash Book, the auditor might be held responsible if he failed to detect the fraud, owing to his omission to examine the records available. This point is one of some importance, as there can be no doubt that where memoranda books are kept which provide corroboration of the books of account an auditor would be held negligent if he failed to examine them. This point emphasises the necessity of the auditor obtaining a list of all books in use.

It is also essential that the auditor should test exhaustively the counterfoils of the bank paying-in book with the debit side of the Cash Book, noting particularly in the case of each payment-in that the separate items making up the total lodgment are the same in both cases.

(2) Credit Sales

Apart from checking the Sales Ledgers, the auditor cannot specifically verify receipts on account of credit sales, particularly where it is not the custom of the business to issue printed counterfoil receipts to its customers. Where counterfoil receipts are in

use, the auditor should ascertain the regulations in force regarding them, and vouch a certain number of the counterfoils with the Cash Book.

It cannot be contended that in a large business which issues receipts it is the duty of the auditor to check the whole of the counterfoils. There is nothing to prevent a smaller amount being entered on the counterfoil than the sum actually received. Further, unless unused counterfoil receipt books are kept in safe custody, there is nothing to prevent receipts being issued from unused books. On the other hand, if the counterfoil is properly filled in, but the entry in the Cash Book is incorrect, and the auditor fails to discover the fraud by omitting to check the counterfoil receipts, he might find himself in a position of some difficulty. All spoilt receipts should be attached to the counterfoils, and cancelled by the auditor, as far as his examination extends. It should be seen that the dates on the counterfoils correspond with those in the Cash Book.

Where no official receipts are issued for sums received by cheque, the daily lists of such receipts, showing the amount and nature of each transaction and the name of the payer, should be verified with the entries in the Cash Book.

Where travellers are authorised to collect money from customers, the regulations in force should be ascertained, and it should be seen that they are sound and regularly adhered to. If the travellers issue counterfoil receipts, the counterfoils should be tested. The travellers' returns, giving particularls of the amounts received, should also be examined and compared with the actual receipts in the Cash Book.

Discount allowed to debtors is usually entered in a special column on the debit side of the Cash Book against the receipt to which it relates. The auditor should ascertain the terms on which discount is allowed, and test a certain number of the entries to ascertain whether the discount is in order. This is important, as defalcations in respect of receipts may be concealed by means of fictitious entries of discount. The discount columns should be cast, and the total checked to the debit of the Discount Payable Account in the Impersonal Ledger.

(3) CASH SALES

The opportunities for fraud in this connection are very numerous, and no amount of checking by the auditor will be of much avail unless an efficient system of internal check is in operation.

Assuming a proper system to be in force, the auditor will test its operation exhaustively by checking the counterfoils of the Cash Sales Books with the salesmen's summaries or abstracts. Each salesman's abstract should agree with the analysis of the cash received by the receiving cashier, the details of which can again be checked with the cash sales counterfoils. The daily totals of the receiving cashiers' Cash Books should be vouched into the General Cash Book.

Where automatic cash registers are employed, the daily totals entered in the Cash Book should be checked with the till rolls.

(D) SPECIAL RECEIPTS

Certain receipts of common occurrence are subject to special considerations in vouching, and the more important of these are dealt with below. Special receipts relating particularly to companies will be dealt with in Chapted VII.

(1) *Income from Investments*

A separate ledger account should be kept for each investment, and where a large number of investments is held, an Investment Ledger will usually be found. In the case of fixed interest stocks the dates when dividends or interest payments are due should be noted at the head of the account. The auditor should ascertain that all dividends and interest receivable have been properly accounted for. Where the rate is fixed, the amount of the dividend or interest can be verified by checking the calculation on the nominal value of the stock held. In other cases, the counterfoils of the dividend warrants should be seen. Where investments are sold *ex div.*, it should be seen that the dividends are subsequently received, and similarly when a purchase is made *cum div.*

(2) *Rents Receivable*

In order to vouch the income derived from this source; the auditor should inspect counterparts of leases and agreements, noting the rent payable, and the provisions as to repairs and allowan-

ces. He should then ascertain that all rents that should have been received have been received, and vouch deductions made by the tenants. Inquiry should be made into arrears outstanding for any length of time, in order to ascertain whether they are genuine. Similar precautions must be taken in respect of properties which are shown as unlet. Where counterfoil rent receipt books are utilised, the counterfoils should be checked. When rents are collected by agents, their accounts should be examined and vouched.

(3) *Interest on Loans and Bank Deposits*

If the loan is secured by a mortgage, the deed will be consulted for the rate of interest and the dates when it is payable. If the loan is unsecured, whatever other evidence is available will be inspected, and it should be seen that the interest is duly received. Interest on deposit will be verified by reference to the bank statement or deposit account pass book, and the correctness of the amount there credited can be tested by checking the calculations in accordance with the terms allowed by the bank.

(4) *Bad Debt Dividends*

These items should be vouched by examining the counterfoils of the dividend warrants or other documents, which will state the amount of the debt and the rate of the dividend.

(5) *Sales of Investments*

The amounts received should be vouched by reference to the brokers' sold notes.

(6) *Bills Receivable*

The Bills Receivable Book will be examined to ascertain the due dates of the various bills. The proceeds of those discounted will be received prior to maturity, and should be vouched by reference to the Bills Book, or Bills Discounted Book, and the rate of discount charged. Those held till maturity should be received in full on the due dates. If not so received, they will either have been retired and new bills given, or dishonoured.

(7) *Miscellaneous Receipts*

Other special receipts, such as receipts from the sale of fixed

assets, receipts from insurance companies in respect of claims, etc., will be vouched by reference to the correspondence, and any other documents relating to the matter.

§ 5. The Bank Statement

(A) Payments into Bank

The desirability of paying all receipts into the bank daily has already been emphasised, and the auditor should check the amounts paid in as shown by the bank statement with the entries in the Cash Book. Note should be taken of the dates of lodgments, to see that they correspond with the dates of receipt. This is important, since cases have been known where the cashier has continuously delayed his banking for a few days, thereby placing himself in a position to manipulate regularly the current receipts.

The auditor should test a representative number of entries with the counterfoil paying-in-book and he should refer to this book particularly for the purpose of vouching money received and paid into the bank prior to the date of closing the accounts, but not credited by the bank till the next period. As the paying-in-book will show the actual date on which the items were paid in, and will be initialled by the receiving cashier, the record will be sufficient evidence that the moneys were paid in prior to the date of closing the accounts, if supplemented by an examination of the bank statement for the subsequent period, to see that the amount has been credited in due course.

In certain businesses it is the custom to enter remittances received after the close of the balancing period, as if they had been received and paid into the bank on the last day of the period, in order that these transactions may be recorded in the books before the close of the period, and so reduce the outstanding debtors. Such treatment cannot be regarded as in order, since it will have the effect of increasing the cash appearing in the Balance Sheet, and decreasing the outstanding debtors correspondingly. In this way the accuracy of the Balance Sheet is affected, but this can be remedied by adjusting the cash and debtors to the extent of the items in question. As, however, the Trial Balance will include these items as having been received, the auditor must vouch the receipt thereof as if they had actually been received

during the period and make the necessary adjustment on the final accounts.

(B) PAYMENTS OUT OF BANK

Where the bank statement has not already been agreed with the Cash Book, it will be necessary for the auditor to check the payments in detail with the statement, and he should be careful to observe that all bank charges, dishonoured bills, returned cheques, etc., have been properly recorded in the Cash Book.

Where, however, the payments are numerous, and a reconciliation statement has been prepared and presented to the auditor, it may not be necessary for him to check the payments with the bank statement in detail, assuming those payments to have been vouched and the credit side of the Cash Book to have been cast. The statement should, however, be checked in detail with the Cash Book for a representative period. Contras appearing in the statement but omitted from the Cash Book, must be examined carefully, and their nature ascertained, particular attention being paid to the dates of the entries. They are occasionally due to errors on the part of the bank, rectified by contra entry, or more often to cheques paid in and returned on account of a technical irregularity. The latter are not usually put through the Cash Book as returned, and the contra entry in relation to them will therefore not appear in that book. Similarly, great care must be taken to ensure that contras appearing in the Cash Book, but not in the statement, are in order. Fictitious contras have sometimes been made to cover up defalcations.

Cheques drawn before the close of the period, and appearing as payments in the Cash Book, but debited in the bank statement in the succeeding period, should be checked through into that period by the auditor as far as possible. Where the method to treating as receipts items received in the succeeding period is adopted, as referred to above, it will usually be found that the same principle is applied as regards payments, with the result that the cash balance is reduced, and the creditors decreased correspondingly. In this case, a similar adjustment should be made to that described as regards receipts, in order that the Balance Sheet may be correct. For the purpose of reconciling the Cash Book balance with the bank statement balance, however, such

items must be regarded as outstanding cheques.

(c) RECONCILIATION WITH CASH BOOK

A reconciliation statement should be prepared and submitted to the auditor, showing how the Cash Book and bank statement balances are agreed, and the auditor should check the details thereof with the bank statement. If no such reconciliation statement is submitted, he will be obliged to prepare one himself, which he will do by taking the balance as shown by the bank statement, adding thereto cheques paid in but not yet credited by the bank, and deducting therefrom outstanding cheques drawn but not yet presented for payment.

In large concerns separate Cash Books are normally used for cash receipts and cash payments respectively. If this is done, the auditor should check the totals therefrom to the General Cash Book in which the balancing is effected, or to a Total Cash Account in the impersonal or private ledger, which is sometimes employed in order to prevent the staff from knowing the bank balance.

The reconciliation of the bank statement with the Cash Book, where there is an overdraft, follows the same lines, but the cheques not credited will be deducted from the overdraft, and the cheques not cleared added thereto.

§ 6. Verification of Cash in Hand and at Bank

Where all receipts are not banked, and all payments are not made by cheque, the balance appearing on the Cash Book will be composed of cash in hand and at the bank, and will be divided accordingly, if separate columns have been utilised for cash and bank transactions, as should always be done.

In such an event, it is sometimes arranged that the cash balance in hand at the close of the period be paid into the bank on that day, and where this is done, the auditor will be able to vouch the asset through the bank statement. Where this procedure is not adopted, the auditor should, if possible, attend on the day of closing the accounts, and verify the balance in hand by actual inspection. This, however, is not usually convenient, and the auditor must then check the Cash Book up to the date of his attendance, and verify the existence of the balance in hand as at that date.

Where there is more than one Cash Account all should be checked up to the same date, and all the balances produced to the auditor at the same time to prevent the substitution of one for another.

The inspection of the bank statement is not sufficient evidence for the verification of the bank balance, since it would not be impossible for a fictitious statement to be presented to the auditor. It is therefore essential that the balance as shown by the bank statement should be verified by a certificate from the bank sent direct to the auditor. The bank should be asked to specify the balances on all the accounts of the client if more than one are maintained.

Cash on deposit should be verified in a similar manner, and if deposit receipts have been issued these should be examined.

§ 7. Petty Cash

(A) General Considerations

The treatment of petty cash payments is often regarded as an unimportant matter, and it is common to find in the case of businesses which have not been subject to audit, that the petty cash arrangements are very inadequate, and afford numerous opportunities for manipulation. Under these circumstances it is essential for the auditor to direct particular attention to this subject, and he should recommend the adoption of a proper system. This is the more important as vouchers cannot be obtained for a large number of petty cash payments. Moreover, in most businesses of any size, the payments, though small in individual amount, are very numerous, and it will not be possible for the auditor to satisfy himself, by the usual method of vouching, that all the payments are in order.

In small businesses cheques drawn for petty cash are often posted to a Petty Cash Account in the Impersonal Ledger, and the details of the petty cash itself recorded in a rough Cash Book. In such cases, the auditor will usually find on inquiry that there are no vouchers worth speaking of to support the payments, and the book is not subject to the examination of anyone other than the petty cashier. The expenditure made will probably not be analysed, but the total debited to the Petty Cash Account in the Impersonal Ledger, less the balance in hand, will be written off

to Profit and Loss Account.

Such a system should be discouraged by the auditor, and he should recommend the adoption of a columnar Petty Cash Book, containing on the debit side a column for receipts, and on the credit a column for total payments, with subsidiary columns for the various classes of expenditure usually incurred. Each item of expenditure should be extended into its appropriate column, and the book balanced at least once a month. A column should be provided for the voucher number, and the vouchers should be numbered and filed in order. It is advisable to provide an additional column, into which to extend items for which there is no specific subsidiary column and from which each item will be posted to the debit of the account to which it relates.

There are two methods of regulating payments to the petty cashier, the first being to draw cheques as and when required for petty cash purposes, these being entered in the receipts column of the Petty Cash Book.

The second method is known as the *imprest system,* under which the petty cashier receives a starting sum, the amount of which will be determined by the normal demand on the petty cash. When the petty cash requires replenishing, a cheque is drawn for the precise amount of the payments that have been made, thus restoring the balance to the amount of the imprest. This system has certain advantages in most cases, since it necessitates the Petty Cash Book being kept regularly written up, as the petty cashier should be required to furnish an analysis of the payments made each time that he requires a further cheque. It is particularly applicable where the petty cash relates to a branch, or when it is inconvenient to draw petty cash cheques at short notice. In other cases, it might be disadvantageous, since it might result in placing a larger balance in the hands of the petty cashier at the commencement of each period than is necessary. On the other hand, the imprest system is convenient for checking purposes, since at any moment the cash in the hands of the petty cashier, plus any vouchers for payments made since his balance was last replenished, should be equivalent to his original opening balance.

(B) INTERNAL CHECK AS REGARDS PETTY CASH

It has been pointed out that it is not usually possible for the auditor to verify the petty cash transactions in detail, and therefore it is advisable that, in addition to a good system of account, there should exist an efficient internal check, by means of which the petty cash can be kept effectively under control.

The points to which such a system should be applied are as follows:—

(1) The petty cashier should be a reasonably responsible official, but should not himself be the cashier.
(2) The only receipts paid into petty cash should be cheques drawn for that purpose. Sundry cash receipts are often entered in the Petty Cash Book but this is inadvisable, and the rule should be enforced that all receipts, however small, should pass through the cashier's hands, and be paid into the bank.
(3) No payment should be made unless a proper voucher is obtained. Many payments are, however, of such a nature that no receipt is available, and to enable a proper record thereof to be obtained, petty cash slips or dockets should be provided, and the person making the payment should be required to insert the necessary particulars, and initial for the sum received, the docket being counter-initialled by a responsible official where necessary. In this way either an actual receipt or a docket will be in evidence for each payment.
(4) At frequent intervals the Petty Cash Book should be checked in detail with the vouchers, and the balance in hand verified by some responsible official, who should initial the Petty Cash Book accordingly.
(5) No employee should be allowed to borrow from the petty cash under any circumstances.

(C) THE AUDITOR'S DUTY IN RELATION TO PETTY CASH

Where a good system of petty cash, supported by an efficient internal check, is in force, the auditor will not, as a rule, find it necessary to perform much detail work. He should ascertain

that the system is regularly carried out, vouch the cheques drawn for petty cash from the credit side of the Cash Book to the debit side of the Petty Cash Book, and cast the receipts and total payments columns of the latter. The totals of the subsidiary columns should be cross-cast, and agreed with the total payments.

The vouchers should be tested, either by taking a certain consecutive period, or by examining all vouchers over a certain amount. When examining vouchers the auditor should take great care to see that the amounts thereon have not been altered or, if they have, that the alterations have been signed by a responsible person.

Most firms whose expenditure on postage is considerable, use approved franking machines. In such cases cash will not be required for the purchase of postage stamps so that neither cash nor stamps will be available for misappropriation. The franking machine is set by the postal authorities for the number of frankings purchased, for which payment will be made by cheque, and meters show the number of frankings used and the balance in hand. A postage book may be kept as a record of the dispatch of letters, but in the majority of cases today, such a record is dispensed with.

Where postage stamps are used, the cash for their purchase will, normally, be provided out of petty cash and the amounts so drawn must be checked from the Petty Cash Book to the Postage Book. It should be seen that the Postage Book has been regularly checked, and it may be advisable to count the balance of stamps in hand where this is considerable. The main point, however, is for the auditor to see that a proper system of check on the postage is in force, since otherwise the opportunities to commit fraud may prove too tempting to be resisted.

Where the Petty Cash Book is kept on the columnar principle, it may be made to form part of the double entry, and, in that event, there will be no Petty Cash Account in the Impersonal Ledger, and the balance of the Petty Cash Book will form part of the Trial Balance. The totals of the columns will, in such a case, be posted direct from the Petty Cash Book to the Impersonal Ledger, and should be checked by the auditor. Otherwise a Petty Cash Account will be opened in the Impersonal Ledger, which will be debited with all cheques drawn for petty cash, and

credited with the analysis of the various payments, either through the Journal, or by way of direct transfer to the ledger accounts involved. The auditor should vouch such transfers with the analysis of the petty cash, and see that the balance brought down on the Petty Cash Account in the Impersonal Ledger agrees with the balance as shown on the Petty Cash Book.

Where the petty cash system is not adequate, and where there is no effective internal check, the auditor should examine the transactions carefully, and vouch them as far as possible. Where the evidence of payment is not sufficient, he must report to his clients the facts of the case, and inform them that he cannot hold himself responsible for the accuracy of petty cash transactions, owing to the lack of available evidence.

In any event, the auditor should verify by actual inspection the balance in hand. Where possible this should be done without previous warning and not confined to the day of the Balance Sheet. The Petty Cash Book must be vouched up-to-date and the petty cashier called upon to produce his cash balance. It will sometimes be found that such balance consists in part of IOU's. Due note should be taken of these by the auditor, and he should report the matter to his clients.

Where two or more Petty Cash Accounts exist, the balances should be verified simultaneously, in order to avoid substitution of one balance for another.

In the case of the *London Oil Storage Co., Ltd.* v. *Seear, Hasluck & Co.* (Acct. L.R. 30, p. 93), it was found that the auditors had committed a breach of duty in not vouching the existence of the petty cash balance, which was shown by the books to be £796, but was in fact only £30. The mere size of the alleged balance should, of itself, have aroused the auditor's suspicions.

CHAPTER III

THE AUDIT OF TRADING TRANSACTIONS

§ 1. Purchases

(A) Internal Check as regards Purchases

It is highly important that a proper system should be in force for the purpose of checking the receipt of goods and the accuracy of invoices, in order to prevent fraud and errors, and to ensure that the business only pays for the goods which it actually receives.

Before entering on an examination of the purchases the auditor should ascertain what system, if any, is in force, and the following are the principal points to which his attention should be directed:

(1) Which officials are authorized to sanction the ordering of goods?

(2) Whether a Goods Inwards Book is kept by the gate-keeper, in which particulars of all goods received are entered?

(3) Whether the invoices, when received, are checked by the invoice clerk with the Order Book, and the number of the order entered on them? The invoices should also be checked with the Goods Inwards Book, to ascertain whether the goods have been actually received, and a reference made both in the Goods Inwards Book and on the invoices. This should prevent the entering of fictitious invoices or the treatment of duplicates as originals. The invoice clerk should initial each invoice, to indicate that he has checked the calculations and verified the items as above described.

(4) Whether each invoice is then passed to the particular department from which the goods were ordered, the manager of which should initial the same, thus making himself responsible for the correctness of the price and quality of the goods?

(B) THE BOUGHT DAY BOOK

As stated in the previous chapter, many firms now dispense with Bought Day Books and Bought Ledgers by dealing with purchases on a cash basis. Invoices received from suppliers, after they have been checked, are filed in "unpaid accounts" files until they are due to be paid. When the cheques are drawn in settlement, the invoices are marked "paid" by means of a rubber stamp and then filed in appropriate files for paid accounts. The cheques are sent to the suppliers together with their statements, or with remittance slips made out by the paying firm, and the amounts thereof entered in a purchases column in the Cash Payments Book. If the cheques are made out by means of a special typewriter, a carbon copy is taken which forms a subsidiary Cash Payments Book, the total of which is entered in the purchases column of the general Cash Payments Book.

Where Bought Day Books are still utilised, it is often found that invoices for services, etc., as well as those for goods purchased, are entered therein, as accounts for all creditors are kept in the Bought Ledger. In these circumstances, a columnar day book is generally employed, the book providing a separate column for each class of expenditure or for departmental analysis.

The amount of each invoice will be entered in the Day Book, and the invoices numbered consecutively. Where the system of internal check is adequate, it will be sufficient for the auditor to test the casts and cross-cast of the subsidiary columns to see that they agree with the grand total. The postings of the totals of the subsidiary columns will be checked to the accounts in the Impersonal Ledger to which they relate.

Where the number of columns required is too large to be dealt with conveniently in one book, the Bought Day Book should be divided into two or more sections. In such cases it is usual to find an Expenses Day Book in operation, recording all invoices relating to expenses other than purchases of goods.

It will be appreciated that if purchases of goods and expenditure on services, etc., are dealt with on a cash basis, the auditor, when vouching the payments made to creditors, will be concerned also with the nature of the consideration for such payments and the accuracy of the postings made in respect thereof to the relevant impersonal ledger accounts. The following remarks on

vouching invoices, therefore, are equally applicable to the auditor's examination of invoices entered in a Bought Day Book as to his inspection of invoices in corroboration of cheque payments where no day book is kept.

(c) VOUCHING INVOICES

The auditor should see that the invoices are initialled by the clerk whose business it is to check them. Each invoice relating to goods should have attached to it a docket signed by the gate-keeper acknowledging receipt of the goods or bear a reference to a Goods Inwards Book, to which the auditor should occasionally refer to see that the goods stated in the invoice have actually been received. Care should be taken to see that the invoices are made out in the name of the firm, and appear to be of a nature relating to the business carried on. It should be seen that each item is extended into its proper subsidiary column in the Bought Day Book or Cash Payments Book, and if any column is provided for capital expenditure, such as plant and machinery, the items contained therein should be checked to see that they are strictly of a capital nature. All such items should be passed and initialled by some competent official.

In some businesses it is the practice to allow members of the staff to order goods for themselves and to obtain the benefit of trade discounts. Unless special care is exercised in relation to such goods there is the possibility of their not being correctly charged out to the recipients, and the auditor should take care to see that each such invoice has a corresponding sales invoice.

At the close of the balancing period it is important for the auditor to ascertain, as far as possible, whether all goods received prior to the date of closing the books are included in the purchases, since, if they are included in the stock but omitted from the purchases, the profit will be over-stated to that extent. Profits can be inflated deliberately by manipulating the purchases in this manner, and where no proper system for dealing with the receipt of goods is in force, it may be difficult for the auditor to detect fraud or errors of this nature.

Where, however, the gate-keeper's records are referenced to the suppliers' invoices, there should be no difficulty in ascertaining whether or not the liability for all goods received prior to the date

of the Balance Sheet has been correctly dealt with.

In the absence of adequate gate-keeper's records, it may be necessary for the auditor to refer to the suppliers' delivery notes received with the goods.

Errors occasionally arise in this connection owing to the system sometimes adopted in certain trades of post-dating invoices. This is done for the purpose of giving an extended period of credit—all goods ordered, say, after the 20th of each month being post-dated to the 1st of the following month, in order to extend the term of the two or three months' credit that may be allowed. For the convenience of the ledger clerk, it is usual to make the entries relating to these invoices as at the 1st of the month, although the goods themselves have been received in the previous month; and care must be taken at balancing periods to ascertain that all goods of this nature brought into stock have been properly dealt with as purchases.

Where the firm has dispensed with a Bought Day Book and Bought Ledger, the invoices in the "unpaid" accounts files should represent the outstanding liabilities at the Balance Sheet date. The auditor must call for the list of such invoices, prepared at the close of the financial period, and vouch therefrom the adjustments made on the relevant impersonal ledger accounts. Each item on the list, or a representative number thereof, must be vouched by reference to the appropriate invoices, which have probably been paid before the audit is commenced. The auditor must also take the normal precautions to ensure that the list of outstanding liabilities is complete, bearing in mind the fact that the absence of a Bought Day Book has possibly increased the risk of omissions.

It is customary in many businesses to allow *trade discount*. This discount is an allowance made by one firm to another in the same trade, and takes the form of a percentage of the catalogued or fixed price of each article. It varies greatly in different trades, and even on different articles in the same trade, and bears no relation to the payment of cash. The deduction is made from the invoice at the time it is rendered, and in vouching the invoices the auditor should see that only the *net* figure is entered.

Cash discount, on the other hand, is an allowance made by the seller to the purchaser in consideration of the latter paying his account at once, or within the period of credit allowed. Such dis-

count, as affecting purchases, is usually recorded in a discount column on the credit side of the Cash Book, the discount being entered therein, and posted to the debit of the account in the Bought Ledger. Where such discount is regularly taken advantage of, it is sometimes deducted from the invoice before the entry is made in the Day Book. Such treatment cannot be recommended, however, as the ledger account with the creditor will not agree with the statement rendered by him.

Where purchases are dealt with on a cash basis, the debits to Purchases Account from the totals of the appropriate columns of the Cash Payments Book will represent the net cost of purchases, as the cheques drawn will be for the net amounts payable after deduction of cash discounts. If the firm desires to show the amount of discount received as a separate item in its Profit and Loss Account, it will be necessary to record discounts taken in a special column in the Cash Payments Book and for the total of such column to be posted to the debit of Purchases Account and to the credit of Discount Account. It is doubtful, however, whether the information so obtained would justify the clerical labour involved.

(D) FORWARD PURCHASES

In many businesses forward contracts are placed for the purchase of commodities, and in such cases it will be necessary to decide whether provision should be made in the accounts for any potential loss which may arise from a fall in the market price of commodities contracted to be purchased but not yet delivered. Practice is not consistent on this point, but it would seem that so long as a company is merely following its usual procedure in entering into such contracts, and market fluctuations are not abnormal, no special provision need be made for the difference between the contract price and the market price at the date of the Balance Sheet. If, however, *exceptional* forward commitments have been entered into, the outcome of which may adversely affect the financial position of the company, suitable disclosure should be made in the Balance Sheet, and the auditor should qualify his report if it is not made (*Rex* v. *Bishirgian and Others.* The "Pepper Pool" case). Even though the commitments are not abnormal, if it appears that a substantial loss will probably

arise in connection therewith, the auditor should refer to the matter in his report unless the prospective loss is fully provided for.

§ 2. Purchases Returns

The auditor should ascertain that a proper system is in force with regard to the treatment of purchases returns, so as to ensure that full credit is obtained for all goods returned. The department concerned should advise the acounts department of all goods returned, and this advice note should be checked with the original invoice, and the proper entry made in the Bought Returns Book, If the invoice has not already been paid, the advice note will be attached thereto in order that it may not be overlooked when payment is made. If the original invoice has been paid, a credit note should be obtained from the creditor, and placed with the invoices not yet paid, so that it can be seen that the proper deduction is made from the next payment.

The form of the Bought Returns Book may be of a columnar nature, and similar to that of the Bought Day Book. Where Bought Day Books, are dispensed with the advice notes or credit notes will be attached to the invoices in the "unpaid" accounts files.

§ 3. Sales

(A) Credit Sales

The auditor should ascertain the system in force relating to the record of sales from the time that the order is received until the invoice therefor is rendered to the customer. The system adopted will naturally vary with each class of business, but a proper record must be kept of all goods sent out. Much saving of labour is effected by the adoption of a system whereby three copies of each invoice are obtained simultaneously by the use of carbon paper. The first copy will be sent to the customer, the second used as a delivery note, and the third filed in a suitable manner.

In the majority of businesses, the copy of the invoice sent to the customer will be used as the medium for posting the sale to his account in the Sales Ledger. If this system is adopted only

the date, invoice number and the amount need be entered in the Sales Day Book which can, of course, be provided with analysis columns if it is desired to analyse sales between different commodities or geographical areas. In many cases, however, a Sales Day Book is dispensed with, the copies of the invoices rendered being totalled daily or weekly by an adding and listing machine to provide the credit to be made to the Sales Account.

In some businesses, where the number of invoices rendered to each customer within the period of credit granted is small, and such customers, in the main, pay their accounts regularly in full, even Sales Ledgers are dispensed with. Where such a system is operated, the copies of the invoices rendered are filed in a suitable folder for each customer until they are paid, when they will be removed and filed in numerical or other convenient order. If credit notes are issued, copies thereof will be inserted in the appropriate folders which will thus contain a record of all amounts due by trade debtors. To guard against the danger of unpaid invoices being lost or removed from the folders with fraudulent intent, Control Accounts must be kept, the balances on which should, at any time, equal the aggregate of the unpaid invoices, less credit notes, to be found in the customers' folders. The Control Accounts will be written up from the daily totals of invoices rendered, credit notes issued and cash received from debtors.

The auditor's work in connection with credit sales must, therefore, be determined by the method of accounting in operation and the view which he takes of the system of internal check in force. In all cases, however, it is clear that to follow through a representative number of transactions from the primary records, *e.g.*, customer's orders to the ultimate receipt of cash, is of greater value than the mechanical checking of postings from a Sales Day Book or the automatic acceptance of carbon copies of sales invoices.

If a Sales Day Book is kept, a representative number of the entries should be vouched with the carbon copies of the sales invoices and a reasonable proportion of the postings checked to the Sales Ledgers. The casts of the book should also be tested and the totals checked to the Sales Account.

Where the Sales Day Book has been dispensed with, the carbon copies of the sales invoices being listed and added by machine,

a number of the machine lists should be checked with the relevant copies of the invoices and the totals checked to the Sales Account.

If Sales Ledgers are not kept, the auditor should test exhaustively the Control Accounts and agree all or some of the balances thereon with the aggregate of the unpaid invoices and credit notes in the relevant customers' folders, which he should ask to be listed for this purpose. The auditor will examine the lists of unpaid accounts extracted at the date of the Balance Sheet and:

(*a*) agree the totals with the relevant Control Accounts;
(*b*) test the subsequent payment of a representative number of items;
(*c*) enquire carefully into any amounts cleared after the Balance Sheet date by what appear to be unduly large credits for returns, allowances, etc.

Where the business is that of a manufacturer or wholesaler, and the goods sold are subject to Sales Tax, the amount of the Sales Tax must be disclosed separately on the relevant sales invoices, and should be entered in the Sales Day Book in a separate column or listed separately on machine lists, for posting to the relevant Sales Tax Account in the Impersonal Leldger, which in effect represents a personal account for the Government concerned. The auditor should take care to see that all Sales Tax has thus been segregated from the sale price of the goods themselves.

Occasionally sales will be made of old plant and machinery, or other assets of a capital nature. The auditor must take care to see that the amounts derived from such sales have not been included in general sales.

A representative number of sales invoices should always be checked with the Goods Outwards Book, to ascertain that the goods in question have actually left the premises. This test is particularly useful towards the close of the accounting period, in order to discover whether sales really belonging to the succeeding period have been treated as sales for the current period, although the goods themselves may not have been despatched, and may also have been included in stock, thus creating a fictitious profit.

(B) CASH SALES

It has already been pointed out that it is essential that there should be an efficient method of recording transactions of this nature. Where the book-keeping system is indifferent, it will frequently be found that the cash sales are merely entered as cash is received, and that there is no method by which the auditor can verify their accuracy. In such cases, he should disclaim any responsibility in connection with the item, and suggest that a proper system be introduced. The vouching of cash sales, where an efficient system is in force, has already been dealt with in Chapter II, 4(C).

(C) GOODS ON SALE OR RETURN

Where goods have been sent to customers on sale or return, the auditor should ascertain that unsold goods in the hands of customers at the date of the Balance Sheet are not treated as sales, but are brought into account as stock in the hands of customers, at cost price, a percentage being deducted where necessary for damage. It is a primary rule that no credit should be taken for profit on a sale until the sale is actually effected.

It may be found that transactions of this nature are not properly recorded, but are included in the ordinary records of sales, the sale price being debited to the customers' accounts in the Sales Ledger and corresponding credit given if the goods are returned. In such a case, the debtors' balances will include goods in the hands of customers at selling price, and the sales will have been correspondingly increased. The auditor should require a schedule of goods in the hands of customers to be prepared, and if it is inconvenient to adjust the individual debtors' accounts in the Sales Ledgers, he should see that an appropriate adjustment is made in the Sales Account so that sales and debtors are reduced to their correct figures. The stock in the hands of customers should then be valued at cost or under, and brought to the credit of Trading Account, and shown on the Balance Sheet as an asset.

(D) GOODS ON CONSIGNMENT

(1) *Consignor's Books*

Following the principle that no profit should be taken until the

sale is actually effected, where goods are sent on consignment, the auditor should ascertain that credit has only been taken for profit in respect of goods actually sold prior to the date of the Balance Sheet. Where it is desired to show the profit or loss on each consignment, a separate Consignment Day Book is normally used, the goods sent out being passed through this book at cost, and debited to a Consignment Account. Any freight, insurance, or other expenses incurred by the consignor are also debited to the Consignment Account; and on receipt of the account sales from the consignee an entry will be made, crediting the Consignment Account, and debiting the consignee's personal account with the *gross* proceeds. The latter account will be credited with the consignee's commission and charges, the Consignment Account being debited. The balance on the Consignment Account will then represent either profit or loss, unless some portion of the goods remains unsold, in which event they should be valued at cost, or under, as the case may be, brought down as a debit balance on the Consignment Account, and appear as an asset on the Balance Sheet.

Where consignments are treated in this way, each Consignment Account will represent a Trading Account in respect of the goods sent on consignment, and consequently the sales in connection therewith will not go to the credit of Sales Account. The auditor should ascertain that the goods have been actually debited to the Consignment Account at cost, and inspect the account sales rendered by the consignee, and any account current he may have furnished, which will afford respectively an indication of the sales made, the stock-in-hand, if any, and the balance of the consignee's personal account.

Although the system above described is the best where it is desired to ascertain the result of each consignment, it is not always adopted in practice. Goods are not, as a rule, invoiced at cost price, but at an estimated selling price, sometimes for the purpose of insurance, and sometimes in order that the consignee shall not be aware of the actual cost of the goods consigned to him. In such cases, it is common to find the goods consigned treated as ordinary sales, a personal account for the consignee in the Sales Ledger being debited therewith. If the goods remain unsold, or if the consignment is not closed at the date of the

Balance Sheet, and the necessary adjustments are not made, this treatment will be incorrect, as credit will have been taken for sales not actually made, and the consignee will appear as a debtor, whereas in fact he is only liable to account for the proceeds of the goods or the goods themselves. In such a case, the auditor should see that the accounts are properly adjusted, and that consigned stock remaining unsold is brought in at a proper valuation, according to the circumstances.

(2) *Consignee's Books*

In auditing the accounts of a business which receives goods on consignment for sale on behalf of a principal, the auditor should ascertain that such sales are kept entirely distinct from the ordinary sales effected by the business. A separate record of such sales should be kept, the total thereof being posted to the credit of the personal account of the consignor, and not to Sales Account. In the same way, care must be taken to see that no stock which is the property of consignors is included as part of the stock belonging to the consignee's business. For these reasons, it is desirable that no entries should be made in the consignee's books (except the stock record in a Consigned Stock Book) until sales are actually effected, when the various debtors concerned will be debited, and the consignor's personal account credited. Commission and charges will be debited to the consignor, and credited to the respective nominal accounts. The auditor should ascertain by the inspection of contracts, correspondence, etc., the terms of the arrangement, and in cases of importance, a signed copy of the consignor's account should be obtained for the purpose of verifying the balance. It is usually necessary to reconcile the balance of such an account with the balance as shown by the consignee's books, owing to the existence of items so far dealt with by one of the parties only.

(E) SALES FOR FUTURE DELIVERY

In certain businesses contracts are entered into for forward sales, delivery being made, either at stipulated times, or, as and when called for within a certain period. Although a valid contract may exist, it is not desirable that any profit should be taken in advance in connection with transactions of this nature, and the

auditor should ascertain that only those goods which have been actually delivered at the date of the Balance Sheet have been treated as sales. This applies particularly where the goods are not yet ready for delivery, and the necessary expenditure has not yet been incurred. Even where the goods under contracts of this nature are ready for delivery at the date of the Balance Sheet, they should be treated as stock and valued at cost price. Cases will sometimes be met with where the purchaser pays cash down for a quantity of goods, but does not take delivery of the whole, leaving a portion with the seller until the goods may be required. In such an event, it may be argued that the whole sale has taken place, and that profit can properly be taken in respect thereof, the goods undelivered at the date of the Balance Sheet not being brought into stock, but being regarded as belonging to the purchaser, and held for his account. The auditor must take all the circumstances into consideration in deciding whether this treatment can be permitted.

(F) Sales under Hire Purchase Agreements

Where hire purchase trading is conducted, it is sometimes the practice to take credit for the full cash selling price of the goods in the year in which the contract is entered into and to treat the hirer as a debtor for the instalments not yet due at the date of the Balance Sheet. In other cases, Sales Account is credited only with each instalment payable under the contract as and when it becomes due, so that the profit on the contract is spread over the whole period during which the instalments are payable. The latter method is strictly the more correct, as it results automatically in no credit being taken for profit not yet realised. The auditor must, however, be careful, where this method is followed, to see that the amount of the unpaid instalments, reduced by the percentage of profit estimated to be included therein, is credited to the Trading Account and brought into the Balance Sheet as stock out on hire. Where credit is taken at the outset for the full selling price of the goods, provision should be made at the date of the Balance Sheet for an amount equal to the unrealised profit included in the unpaid balances on hire-debtors' accounts, such provision being deducted from the total of such balances in the Balance Sheet. Where the total of the instalments represents the

cash selling price plus interest on the diminishing balance of principal outstanding, the auditor should see that credit is taken in each year only for such interest as has actually accrued during the accounting period.

§ 4. Sales Returns

The method of recording goods returned by customers should be enquired into by the auditor. Appropriate records should be kept by the gate-keeper, recording the necessary particulars, which should furnish the basis of the credit notes issued. If a Sales Returns Day Book is kept the auditor should check the casts and the postings to the Impersonal Ledger. A certain number of the entries should be tested with the gate-keeper's records, and in the case of large items, it may be desirable to refer to the correspondence, etc. It should be seen that all credit notes are approved and initialled by a responsible official before being issued. Where stock records are kept, the larger entries should be checked therewith to see that the goods were actually received back.

If the postings to the Sales Ledger are made direct from the copies of the credit notes issued, a Sales Returns Day Book will probably be dispensed with. In such circumstances, the copies of the credit notes will have been listed and added by machine at appropriate intervals to provide the totals to be posted to the debit of Sales Account. The machine lists should be tested by the auditor with the carbon copies of the credit notes and the totals checked to the Impersonal Ledger. A representative number of credit notes must be tested with the gate-keeper's records, correspondence, etc., to confirm that the goods were, in fact, returned.

§ 5. Containers

Many firms deliver their products in cases, bags or other forms of container which are returnable by the customer. The auditor must ascertain the exact terms on which such containers are issued and give careful consideration to the method of accounting for them which is in operation.

Where no charge is made to customers for containers provided that they are returned within a stated time, the auditor should satisfy himself that the records kept of issues and returns are ade-

quate and that there is a proper system in force for invoicing customers for containers they have failed to return within the stipulated time. The records should show the numbers of each class of container in the hands of customers at the date of the Balance Sheet and the auditor must satisfy himself that the value placed on this stock is reasonable, having regard for normal deterioration arising from usage. The charges made to customers for containers not returned must be tested and the possibilities of bad debts, disputed accounts, etc., given careful consideration.

In those cases where customers are charged with containers issued and given credit in full for the amounts charged when the containers are returned, the auditor must take care to see that normal sales and trade debtors are not inflated by such charges and that due regard is had for the liability to give credit in due course for containers in customers' hands at the date of the Balance Sheet. It will be appreciated that the fact that a customer has paid his account in full does not necessarily mean that he will not return containers at a later date and demand the appropriate credit note.

When the charge made to a customer for a container is higher than the credit he will be given on its return, the excess represents a profit for which immediate credit may be taken. The auditor should, therefore, satisfy himself that the accounting entries segregating the excess from the total charged are made correctly.

The provision made for the liability to accept returns from customers may be deducted from the total of trade debtors for Balance Sheet purposes or it may be included therein as a liability with other provisions.

§ 6. Allowances

It will be appreciated that cash defalcations may be concealed by putting through fictitious entries under the heading of "Allowances," and it is therefore of the utmost importance that the auditor should examine the allowances recorded, in order to ascertain that they are in order.

A separate Allowances or Credit Book may be kept, which will be written up from the counterfoils or duplicates of the credit notes sent to the customers. Alternatively, the carbon copies of the credit notes may be listed by machine, the lists then becom-

ing the equivalent of an Allowances or Credit Book. Credit notes or counterfoils should be initialled by the manager of the department concerned, and the auditor should test entries of any consequence, where necessary referring to the correspondence, or to any other evidence available. The totals of the Allowances Book or machine lists should be checked to the Impersonal Ledger and the casts of the Allowance Book, if any, tested.

§ 7. The Journal

The use of the Journal is principally confined to recording opening, closing, and adjusting entries, and all entries of a special nature, for which no separate subsidiary book or record is kept.

The auditor should check the postings to the respective ledger accounts, and ascertain that each entry is in order. It is necessary that narratives should accompany the entries, explaining their nature, and referring to whatever evidence may be available for the purpose of substantiating them. Such evidence will take the form of correspondence, contracts, minutes, resolutions, etc., and should be examined by the auditor.

Vouching the Journal is as important as vouching the cash, since Journal entries may be made which have a material bearing on the accounts. Entries of a complicated nature are frequently found in this book and these must be considered most carefully by the auditor before they are passed.

The auditor should check the casts of Journal entries composed of more than one item. In some cases, both clumns of the Journal are cast throughout the book, for the purpose of sectional balancing, in order that the analysis of the entries relating to each ledger can be proved. Where this is done, it may be advisable for the auditor to check the casts.

In those continental countries where the Code Napoleon is in force, the use of the Journal is compulsory, and all entries, of whotsoever nature, have to pass through this book in one form or another. In this way proper accounts can be prepared at any time from the material embodied in the Journal.

§ 8. The Bought Ledger

As already stated many firms have dispensed with Bought Ledgers by treating purchases on a cash basis. If, however, such

records are kept and the auditor considers it necessary to check the whole of the detail of the Bought Ledger, the purchases will be checked from the Bought Day Book, the returns from the Returns Book, and the cash and discount from the Cash Book. Entries of a special nature should have been passed through the Journal, and will be checked therefrom. The ledger accounts should be examined, to ascertain that every item has been checked by the auditor, including the balances brought forward at the commencement of the period. The ledger will then be cast, and the balances checked with the schedule of creditors.

Where it is not considered necessary to verify the whole of the detail work the auditor will exercise his judgment in determining how far his examination should extend. Where the balances on the Bought Ledger can be separately proved, as referred to in § 10, the auditor should check the Total Account representing the Bought Ledger, and see that the balance thereon agrees with the total of the individual balances.

In examining the balances on the Bought Ledger, the auditor should see that the composition of each balance represents some definite item or items. If this is not apparent, and the account is of a complicated nature, it is desirable to obtain the last statement rendered by the creditor, and to compare this with the ledger account, in order to see whether there are any items in dispute, in respect of which deductions or provision ought to be made.

It has already been pointed out in § 1 that profits may be inflated by including in stock goods for which the purchase invoice has not been entered in the Bought Day Book prior to the Balance Sheet date.

As stated in § 1, (c), the auditor should ascertain that invoices have been correctly dealt with for all goods which, according to the gate-keeper's or other records, were received during the last few days of the accounting period. As an additional precaution, the auditor should check the schedule of creditors' balances with their statements. If the client will agree, it is a good plan, at least once every few years, for a circular letter to be sent to all firms with whom the client deals, asking them to send direct to the auditor a statement showing the balance, if any, due to them at the Balance Sheet date. If this is done, the list of firms to whom the letter is to be sent must be prepared by the auditor

and, obviously, such list must not be confined to firms whose accounts appear to show outstanding balances. It will normally be found that a number of firms to whom the letter is sent ignore the request but, if the check is to be effective, these must be followed up until a reply is received. The auditor will check the statements so received with the schedule of balances and enquire carefully into any discrepancies revealed.

Debit balances will occasionally be found on the Bought Ledger and these should be enquired into carefully. They may represent returns made after the goods have been paid for, in which case, if the item has been outstanding for any length of time, and no further dealings have taken place, the auditor should ascertain whether the amount is recoverable, and does not repesent items in dispute, or if it does, that provision is made accordingly. Where the debit balance is occasioned by the payment of cash, the presumption is that the corresponding credit representing the invoice for the goods has not been passed through the books. Enquiry should be made to ascertain if this is the case, and if so, the outstanding liability should be provided for and the goods taken into stock. Where goods not delivered at the date of the Balance Sheet have been paid for in advance, a credit entry should be passed through the Bought Ledger account, if the property in the goods resides in the purchaser, the goods being taken into stock as in transit, or as in the hands of the seller. Where the property in the goods has not passed, the item may remain as a debit balance. If the total of the debit balances in the Bought Ledger is material it should not be deducted from creditors but should be included in the Balance Sheet under the heading of Sundry Debtors.

When mutual dealings take place between two parties, it is usual to find an account in the Bought Ledger for purchase, and one in the Sales Ledger for sales effected. If each account is separately settled for cash, no difficulty will arise, but where the Bought Ledger account is settled by contra, the auditor should check the entry, and examine the voucher acknowledging the contra settlement.

If Bought Ledgers are not kept the auditor will verify the amounts due to creditors at the date of the Balance Sheet in the manner explained in § 1, (c), of this chapter.

§ 9. Sales Ledgers

(A) INTERNAL CHECK

It is important for the auditor to ascertain whether there is an efficient system of internal check in operation as regards the Sales Ledgers. Particular reference should be made to the following points:

(1) Whether the cashier has any control over the Sales Ledgers, or any books of prime entry relating thereto, other than the Cash Book. If this is so, the opportunities for the concealment of fraud on the part of the cashier are considerable, and the auditor should exercise additional caution accordingly.
(2) Whether the Sales Ledger balances are capable of separate proof, by means of Total Accounts as described in § 10. If so, the total accounts should not be under the control of the ledger clerks.
(3) Whether the ledger clerks take any part in checking their own work. Where there is a sufficient number of clerks, no one should be permitted to do this, but in small businesses such an arrangement may be unavoidable.
(4) Whether monthly or periodical statements are sent regularly to customers.
(5) The arrangements that are in force with regard to the collection of overdue accounts.
(6) Regulations relating to the passing of credit notes for returns, allowances, empties, etc. These have been dealt with above.

(B) THE VERIFICATION OF POSTINGS

The extent to which the auditor may find it necesary to verify the postings to the Sales Ledgers will depend on the circumstances of each case. Where the system of internal check in operation is not entirely satisfactory and the transactions are not too numerous, it may be desirable to check the whole of the postings from the books of prime entry to the ledgers. Where this is not practicable, special attention should be directed to the credit postings, since any attempt to conceal defalcations will more usually take the form of fictitious credit entries. The cash and

discount postings should be checked from the debit of the Cash Book, and this is a convenient occasion for testing discounts allowed, enquiry being made into any discounts which appear to be excessive and into cases where discount has been allowed after the term of credit has expired. The entries from the Returns and Allowances Books, etc., should also be checked, and the auditor should go through each account to see that every item is ticked.

Where the Sales Ledgers are numerous, and there is a good system of internal check in operation, it will be sufficient for the auditor to test the postings. This can be done by checking completely an individual ledger, or by taking individual accounts in different ledgers. It is preferable to check completely accounts that are selected, rather than to rely upon testing individual entries. Note should be taken of the ledgers selected for test, so that in the course of a period of years, the whole of the ledgers may come under review in this manner.

(c) The Verification of Balances

However good the system of internal check may be, and although Total Accounts may be in operation, it is necessary that a representative number of the individual balances on the Sales Ledgers should be examined by the auditor and checked to the schedules.

From the auditor's point of view, it is most convenient if the balances on the Sales Ledgers are brought down at the date of the Balance Sheet but this is not always done, since it is sometimes found more convenient to balance off each account at the time of settlement, rather than at any given date. Although the auditor may prefer that the balances should be brought down, he is not usually in a position to insist upon this being done, but he is entitled to request that the balance of each account at the date of Balance Sheet be inserted in ink at the side of the account, according to whether it is a debit or a credit balance.

When examining the accounts the auditor should ascertain the composition of each balance, it being noted whether it represents specific items of goods, or is an accumulated balance. In the latter case enquiries should be made as to the reason why the account is open as this may be due to errors or disputes in respect of which adjustment or provisions should be made. This exami-

nation of the composition of balances is particularly important where the Sales Ledgers are mechanised for the reasons given in § 12.

Balances representing goods out on sale or return, goods on consignment, etc., require careful attention, and have already been dealt with § 3. The position which arises when Sales Ledgers have been dispensed with was considered in § 3, (A), of this chapter.

(D) BAD AND DOUBTFUL DEBTS

It is not sufficient for the auditor merely to satisfy himself of the correctness of the balances on the Sales Ledgers. It is also his duty to ascertain, from the evidence at his disposal, whether any of the individual balances represent debts which are irrecoverable, or of such a doubtful nature that some provision for possible loss should be made.

In very many cases the period of credit granted to the customers who were debtors at the date of the Balance Sheet will have expired by the time the final audit is commenced and the majority of the outstanding accounts will, therefore, have been paid before the auditor makes his examination of the balances. In such circumstances, the auditor will note on the schedules of balances the accounts which have since been paid in full and concentrate his attention on those still outstanding, or in respect of which only part of the amount due has since been received, or against which credits have been made for returns or allowances. In some cases, however, the period of credit granted will not have expired before the audit is completed and the auditor will, therefore, be compelled to examine a much larger number of accounts, the actual number depending upon his view of the adequacy of the system of internal check in operation.

In examining these balances, the following points should be taken into consideration:

(1) The term of credit allowed by the business.
(2) The age of the debt.
(3) Whether the account is regularly settled within the term of credit, and advantage taken of any cash discount offered.
(4) Whether payments are being made on account, and if so,

whether the balance has tended to increase.

(5) Whether an old balance is being carried forward to be paid off by instalments, new goods being supplied for cash.

(6) Where bills of exchange are received, whether any bills have been dishonoured or retired.

(7) Whether any cheques have been dishonoured.

(8) Whether any notes have been made on the ledger account relating to suspension of payment, deeds of arrangement, bankruptcies, liquidations, receiverships, or of the placing of accounts in the hands of solicitors or debt collectors.

The auditor, before commencing his examination of the ledger balances, should ask that a schedule of bad and doubtful debts be prepared and presented to him. This schedule should be certified by the manager, secretary, or other responsible official, as representing, in his opinion, a complete list of all doubtful debts for which provision should be made. Having obtained such a schedule, the auditor, as he checks the balances, will be in a position to see whether all those debts which appear to him to be bad or doubtful are included therein, and it will only be necessary for him to make further enquiries in respect of any other debts which in his view should have been included in the schedule. These should be marked on the schedule of ledger balances, and discussed by the auditor with some responsible official. If no certified list of bad and doubtful debts is presented to the auditor, he should mark on the schedule of ledger balances all those against which he considers provision should be made.

It is impossible to lay down any hard-and-fast rule as to the valuation of book debts. The term of credit allowed in different businesses varies considerably, and may vary even in the same business for different classes of goods; moreover, in certain cases, the terms of credit are not strictly adhered to, or special terms may be granted to individual customers. The auditor, therefore, will require to exercise considerable judgment in arriving at an opinion, and each case must be taken on its merits. Where the average term of credit is three months, but certain accounts are settled half-yearly or yearly, so long as the settlement is regularly effected, there is no reason why the debt should be considered doubtful. Statutebarred debts, although they may in fact be good,

should be provided for in full, as there is no legal right to recover them.

If payments have been made on account, and the balance against the debtor continues to increase, the auditor should enquire into the circumstances of the debt, and for this purpose it may be useful for him to consult any reports from credit agencies and others, as to the amount of credit that can be safely allowed, and where the amount of the debt is within such limit, and the report is of comparatively recent date, the account may be passed. The payment of an old balance by instalments, while new goods are paid for by cash, is nearly always a sign of weakness, and the old balance should, in such cases, be regarded as doubtful, and provided for accordingly. If the debtor has an arrangement of this sort with one firm, he probably has a similar arrangement with several of his other creditors, and default in payment of the agreed instalment in any one instance may result in pressure being put upon him, and cause subsequent insolvency.

The fact that bills have been dishonoured or renewed is evidence of weakness and a provision may be necessary. If any bills are outstanding on the account, they will, unless discounted, form part of the balance of the Bills Receivable Account, and provision should be made against them accordingly. Where such bills have been discounted, a provision should be made in respect of the contingent liability.

Returned cheques are not necessarily a sign that the account is doubtful, as the return may be due to errors in drafting or otherwise. Where, however, the cheque has been dishonoured for lack of funds, and especially where it was in the first instance post-dated, the account should be considered doubtful.

Notes of insolvencies, etc., are usually made at the head of the account concerned for the convenience of the ledger-keeper, and the information to be derived from them is of material assistance to the auditor. In cases where the debt is of any consequence, the papers relating to the matter should be examined, and the auditor will probably be able to form an opinion from the reports of the trustees, liquidators, etc., as to the proper amount of the provision which should be made. Where final dividends have been received, the balance of the account should be written off.

The fact that an account has been placed in the hands of soli-

citors or agents for collection, does not necessarily mean that the debt is bad or doubtful. The omission to pay may have been due to an oversight or neglect, and not to financial difficulty. The auditor should ascertain the date when the account was put into other hands, and, if any considerable period has elapsed since that time without payment being received, the account should be regarded as doubtful.

Debts should not be written off so long as there is any possibility, however remote, of some payment being obtained. If debts are written off prematurely the account may be overlooked and any opportunity that may subsequently present itself of recovering the whole, or a portion, of the debt, lost irrevocably. Further, in the event of such debts being eventually paid, or dividends received in respect of them, the misappropriation of such sums is facilitated by the fact that no debits appear therefor in the ledger. In order to avoid this possibility, and at the same time to prevent a considerable number of bad debts remaining on the current ledgers, a Bad and Doubtful Debts Ledger is sometimes utilised, to which accounts are transferred as soon as they become doubtful. In this way a check can be kept on the bad debts, and the ultimate loss in respect of each account ascertained.

Bad debts should not be written off without the sanction of some responsible official, in order to prevent the possibility of misappropriations being concealed by the creation of fictitious bad debts. Bad debts written off during the period should be passed through the Journal, the entries being initialled by the authorising official.

As regards the amount of the provision to be made in respect of bad and doubtful debts not actually written off, this should cover the full extent of those debts regarded as bad, while the doubtful debts should be provided for according to their estimated value, having regard to the circumstances of each case.

Where the debts are very numerous and of an average amount, the provision for doubtful debts may be made by way of a percentage on the outstanding debtors, the rate of which will be arrived at from previous experience; but this should be supplemented by specific provisions, if necessary.

Where the auditor, after careful investigation, is of opinion that the provision for bad debts is insufficient, he should endeavour to

induce his clients to make the additional provision which he considers necessary. If, however, he is unsuccessful, his only course is to refer to the matter in his report, stating to what extent he considers the provision is inadequate. The question is one of material importance, since it directly affects the accuracy of the Profit and Loss Account and the Balance Sheet.

If Sales Ledgers are not kept, the unpaid invoices, dated on or before the date of the Balance Sheet, which are still in the customers' folders when the auditor comes to verify the balances due by trade debtors, will represent the accounts into which he must enquire. In addition, however, owing to the lack of ledger accounts, he should pay particular attention to any credits made since the date of the Balance Sheet, but before his inspection of unpaid accounts, which have resulted in eliminating, or reducing substantially, balances which were outstanding at the end of the financial period. Such items as returns, large allowances, bad debts written off, etc., must be scrutinised carefully and the auditor must consider whether, in fact, some provision should have been made therefor at the date of the Balance Sheet.

§ 10. Total (or Control) Accounts and Sectional Balancing

In a business of any magnitude employing handwritten records, the difficulty experienced in balancing the books may be considerable, unless some method is adopted by means of which the Balances of the Sales and Bought Ledgers can be respectively proved. This can be done by the construction of Total Debtors and Creditors Accounts, the Total Debtors Account containing the totals of all items posted in detail to the debit and credit of the Sales Ledgers, and the Total Creditors Account the totals of all items posted to the debit and credit of the Bought Ledgers. The balance on the Total Debtors Account should, at the end of any given period, equal the total of the individual debit balances on the Sales Ledgers, less any credit balances; and correspondingly, the balance of the Total Creditors Account should equal the net balances on the Bought Ledgers.

Control Accounts are, of course, essential if Sales Ledgers are dispensed with in order that a check be imposed on the aggregate of the unpaid invoices, less credit notes, filed in the customers' folders.

In small businesses, where there are only a few ledgers, the system of compiling Total Accounts for debtors and creditors respectively is sufficient for all practical purposes, but, as the number of ledgers increases, some further extension of the principle becomes necessary, if balancing is to be effected accurately and promptly. Where, for instance, there are five Sales Ledgers, only one Total Debtors Account being compiled, representing the whole of these ledgers, and it is found that a difference exists, there will be no means of locating the difference to a particular ledger. In order to overcome this difficulty, a *separate* Total Account should be compiled for each ledger.

Where Control Accounts are in use, the auditor should check or test the postings to the Total Accounts and should see that the balances thereof agree with the net balances on the personal ledgers. If it is arranged that the clerks who take out the ledger balances are not concerned with the posting of those particular ledgers, or with the Control Accounts applicable thereto, it will be unnecessary for the auditor to spend much time in checking the arithmetical accuracy of the personal ledgers.

§ 11. Loose Leaf and Card Ledgers

Where the ledgers used are in loose leaf or card form the auditor must bear in mind the possibility of sheets or cards being accidentally lost or destroyed, and the risk of fraudulent substitution of one sheet or card for another, in order to conceal defalcations. The auditor should, therefore, make enquiries into the system in force for the custody of unused sheets or cards.

§ 12. Mechanical Systems

At one time all accounting records were handwritten, and after the primary documents were prepared, the details thereof were copied into Day Books and then again into ledger accounts. Several records were thus made of the same transaction, with the result that there was unnecessary duplication and clerical work involved was laborious and monotonous. The increase that has taken place in the number of commercial transactions during the last fifty years and the decrease in the number of persons prepared to devote their lives to writing up a Day Book or Sales Ledger have combined to make it necessary to eliminate all records which are not

absolutely essential and, where practicable, to produce two or more records by one operation.

The first step in this direction was made possible by the typewriter, with the aid of which documents could be prepared more rapidly than by hand and, by the use of carbon paper, copies of such documents provided automatically. Once sales invoices were typed and copies taken, it became apparent that to enter full details thereof in a Sales Day Book and to repeat these details in the customer's account in the Sales Ledger was time wasting, as the copy of the invoice was always available for reference when required. The information recorded in the Day Book was, therefore, reduced to the date and number of the invoice, the customer's name and the amount chargeable to him. In the customer's account in the Sales Ledger only the date, number and amount of the invoice were shown. Further consideration showed that the information recorded in the Day Book could be reduced still more by the elimination of the customer's name, if the postings to the Sales Ledger were made direct from the carbon copies of the sales invoices. The Day Book then became a mere record of invoice numbers and amounts, its sole purpose being to provide figures of total sales. The introduction of adding and listing machines has now, in many cases, resulted in the final elimination of the Sales Day Book in its old form. The carbon copies of the sales invoices are listed and added by the machine and the list so prepared is suitably bound or filed to form the equivalent of a Sales Day Book.

Some of the further changes in the process of eliminating, or reducing, the entries in books of prime entry have been:

(*a*) Typing all cheques drawn and using the carbon copy as a Cash Payments Book, the totals of which are entered in a General Cash Book.

(*b*) Printing official receipts in such a form that the carbon copies thereof, totalled by machine, form a receipts cash book and the media for posting the amounts received to the credit of the customers' accounts.

(*c*) The elimination of Bought Day Books and Bought Ledgers by dealing with purchases and accounts for services, etc., on a cash basis.

(*d*) The elimination of Sales Ledgers by filing all invoices rendered in suitable folders until they are paid.

Each of these changes has brought new problems to the auditor by reason of the elimination of records, but the principles of auditing are not affected thereby. The auditor has, however, been compelled to change his methods of verifying transactions and to give much more attention to primary documents, owing to the absence of Day Books but, in the main, this has improved the value of his audit.

The mechanisation of ledgers by the use of book-keeping machines or the punched card system represents merely one further step in the evolution of accounting. The auditor has again, as a result of such systems, to vary his procedures but the purpose of his audit remains the same.

It is not considered to be within the province of this work to deal in detail with the systems of accounting by the use of machines, which are being utilised to an increasing extent in all but the smallest businesses. These systems may be complete or partial. Their function, in the main, is to substitute direct (carbon) copying for posting and to effect mechanically the necessary additions and subtractions.

From the auditor's viewpoint, a mechanised system of accounting has the following disadvantages:

(1) The books consist almost entirely of loose sheets or cards, and unless there is a thoroughly efficient system of internal check with regard thereto, the opportunities for fraudulent substitution or destruction of records are almost unlimited. There may also be a risk that originating documents may never reach the machine operator. The auditor must therefore make very careful enquiry into the system of dealing with these matters before preparing his audit programme, paying particular attention to the methods of numbering prime documents.

(2) An error in an original entry will pass automatically throughout the whole of the records and will not be brought to light by the failure of one set of figures to agree with another.

(3) Less detailed narrative is normally provided than in the

case of hand-written records, and time may be wasted in elucidating doubtful items. The auditor must make himself thoroughly familiar with any system of code numbers that is used in place of a full narration.

(4) Frequently the only permanent record of a transaction is a carbon copy, which can easily be altered.

On the other hand, the work of the auditor will be facilitated by the greater legibility of machine-made entries, and, provided he is satisfied that the system of control over original records is adequate, he need not devote nearly so much time to the checking of detail but should direct more attention to testing the principles of the accounting system (including the internal check) and its practical operation.

If, by means of test checks, the auditor is able to assure himself that the control records do, in fact, prove the arithmetical accuracy of the ledgers, it becomes possible for him to vouch, by means of code references, direct from prime documents to the ledgers.

As an illustration of the manner in which the detailed work of the audit may have to be modified where a system of mechanical accounting is employed, the procedure with regard to sales records may first be considered. The sales invoices are typed and carbon copies thereof are provided, which form the originating documents for the book-keeping entries. From these carbon copies the book-keeping machine, in one operation, debits the customers' accounts, writes up the Sales Day Book Sheet, and makes the appropriate entries on the statements to be sent to debtors at the end of the month or other period. The total amount of the items is accumulated in the machine, and forms the basis of the postings to the Sales Ledger Control Account and to the Sales Account in the Nominal Ledger. It will thus be apparent that, in the absence of any mechanical defect in the machine, the total of the debits to the personal accounts will agree automatically with the total amounts posted to the Control Account and the Sales Account, and it is therefore unnecessary for the auditor to check in detail the individual postings, although a certain amount of test-checking may be desirable.

It is possible, however, for errors to be made in the figures

posted in respect of individual sales, and some independent check is necessary to bring such mistakes to light. It is therefore essential that a "pre-list" of the amounts of the invoices be made on an adding machine, and that the total of this list be agreed with the total shown by the ledger posting machine.

The system is strengthened if the "pre-list" is prepared independently before the batch of copy invoices is passed to the machine operator.

Errors may also arise in the "pick up" of the existing balances on accounts, which is the first step in making a posting. These are normally guarded against by one of the various forms of "double pickup"; if not so prevented they would result in a difference on the Control Account.

A posting to the wrong account in the same ledger (or section where Control Accounts operate sectionally), however, is more difficult to detect as it does not affect the agreement of the Control Account. Systematic sorting of the posting media will minimise this risk and some safeguards can be introduced into the actual posting.

The system of "double run" by which the ledger account and customer's statement are produced independently (preferably on different machines and by different operators) instead of the one being a carbon copy of the other has the great advantage of providing a check upon all three types of error already mentioned It is much used by banks where the accuracy of the ledger balances is, of course, of the utmost importance.

The auditor should take steps to ensure that a proper system is in operation for the correction of errors.

Similarly, with regard to remittances from customers, a machine may be used to write up the official receipts, if any, and to prepare posting slips and Cash Received Books at one operation. This also acts as a pre-list for the subsequent posting of these items to the Sales Ledger Accounts.

A similar routine may be applied to the posting of the Bought Ledger and the payment of suppliers' accounts. Where the Cash Payments Book is produced as a running copy of cheques prepared by a machine, it should rarely be necessary to vouch the Cash Book in detail with the bank statements but adequate tests should be applied. Where cheques are signed by means of signa-

ture plates, the auditor should ascertain that there are adequate safeguards against their misuse.

The copy or control sheet of the postings of suppliers' invoices to the Bought Ledger will serve the function of a Bought Day Book and the extent to which the auditor finds it necessary to vouch this record by reference to the original invoices depends on the thoroughness of the system of internal check. Particular attention must be paid to the analysis of these postings where they cover expenses as well as purchases in the strict sense.

It will be obvious that it should be unnecessary for the auditor to check all the casts of the Day Books or machine lists, but as a precaution he should test a certain number of the sheets, and should be careful to compare the totals thereof with those of the pre-lists. Neither should it be necessary for the auditor to check in detail the balancing of the accounts in the Debtors and Creditors Ledgers. Under a mechanised system each such account is automatically balanced, and the balance extended, every time an entry is made, and provided the auditor is satisfied that the machine is performing its functions and that there are no loopholes for omissions or fraudulent manipulation, this balance may be accepted. The time saved by not having to check the casts and balances of the accounts may be usefully employed in scrutinising their composition in order to bring to light any possible irregularities, and, in the case of the Debtors Ledgers, to verify the provision for bad and doubtful debts.

The Impersonal Ledger, even though written up by machine, should be checked in some detail by the auditor, and, as a general rule, no variation from the procedure followed in the case of handwritten records is recommended.

In the Punched Card system of accounting, the principal machines employed are the punch, the sorter and the tabulator. The punch is used to punch holes in the cards in such positions that they correctly record the transactions represented by the particular cards, *e.g.*, a card recording a sale will be furnished with columns for date, customer's number (and/or folio), description or reference number of article sold, quantity, price, total amount, traveller's number, etc.

The accuracy of the position of the holes punched is checked by repunching the cards with a verifier.

The cards recording similar transactions, *e.g.*, sales, can then be analysed in any way desired by means of the sorter. The cards may be sorted under customers' numbers for posting to the ledger, re-sorted under commodity numbers for posting to the stock ledger, under travellers' numbers for preparation of commission sheets, and for any other purpose that may be desired.

It must be emphasised that the ledger account is not a punched card, but is produced on a suitable form or card in ordinary typewritten form. It is usual to post the accounts monthly (preparing the statement at the same time in the form of a carbon copy) and this may make it difficult to examine the continuation of an account beyond the balancing date.

Where the Punched Card system is employed, the auditor should first satisfy himself that the internal check is such as to ensure that all original records reach the operators of the machines, and that cards are repunched by a verifier before being dealt with further. All information on the original documents should be listed on an adding machine, and agreed with the total obtained by listing and totalling the punched cards on the tabulator. In order to test the accuracy of the punching, the auditor might also select a number of cards and put them through the machines himself, or require an operator to do so under his supervision. All parts of the records should be tested in this way, particular attention being given to the Debtors and Creditors Control Accounts, the balances on which should be compared with the lists of balances on the individual personal accounts. As already stated, the entries in the Impersonal Ledger should be verified in some detail.

In the foregoing paragraphs attention has been directed to the modifications in general auditing technique necessitated by the adoption of a mechanised accounting system.

The following is an extract from the Report of a Sub-Committee of the Taxation and Research Committee of the Institute of Chartered Accountants in England and Wales entitled "Mechanised Accounting and the Auditor" dealing with specific audit difficulties attendant on the use of mechanised accounts, and suggesting remedies to overcome them.

Specific Audit Difficulties

(1) *Absence of Primary Records*

The abandonment in whole or in part of daybooks and journals, in favour of the use of prime documents as direct posting media, is one of the commonest features of a mechanised system although in itself it is no more than a "modern method" particularly suitable for adaptation to mechanisation. This aspect of mechanisation may present three main difficulties to the auditor:

(*a*) The totals (for example of sales) which normally would be provided by the columns of a daybook or journal may not be readily capable of verification. A similar position may arise in respect of the sub-totals normally provided by the analysis columns of a daybook.

(*b*) Documents used for two or more purposes (for example, sales invoices required for posting to personal accounts in the sales ledger and also for regional analyses or salesmen's commission) may have been re-sorted into the order required for a second process, thus presenting difficulty in vouching the totals for the first process.

(*c*) Where the business involves a great number of transactions of the same kind, large blocks of them may be dealt with in one total so that it becomes impracticable to limit test-checks to manageable proportions.

Remedies

In order to meet the foregoing difficulties it is suggested that the control of the accounting system should be tightened by a system of numbering prime documents and of breaking down the means of control to practicable proportions. This would normally be of no less benefit to the client than the auditor. The principal features of control in this way are given below; they involve the introduction of new types of primary records in the form of invoice registers, "batch" registers, summary books and similar records which are integrated with the double-entry system.

(*a*) *Serial numbering of all prime documents in the order of first entry in the accounting records.* This ensures that a document is given a permanent identity immediately it takes its place in the records and thus makes possible adequate cross-referencing of prime documents to the various ultimate records; for example, if the ledger is being posted from original invoices the ledger account reference can easily be recorded on the invoice and the invoice reference number can be recorded in the ledger if the invoices have already been numbered. A decision as to what is the point of "first entry" at which prime documents should be numbered will depend on the individual circumstances and is one of those matters which call for considerable skill in the design of an accounting system. The point at which a "batch" of documents is prepared (as suggested below) may well be regarded as the "first entry" in appropriate cases.

(*b*) *Collection of prime documents, before first entry, into batches of suitable classification and manageable size (for example 50 or 100 copy sales invoices) and the serial numbering of the batches.* This not only facilitates the subsequent tracing of prime documents and enables them to be filed in accessible manner, but is also of vital importance in maintaining an adequate control over operations. Thus, by means of appropriately-designed batch cover-sheets the various stages through which a batch of documents passes can be recorded and each batch is sufficiently small to enable a close control to be imposed at every stage on the monetary amount it represents.

(*c*) *Permanent filing of batches in batch-number order.* This is an essential conclusion to the handling of documents in batches as suggested in (*b*) above. To avoid risk of documents being lost through carelessness during subsequent reference and to facilitate the actual filing, it is advisable to secure each batch by wire stitching, stapling or similar permanent binding.

(*d*) *Maintenance, as an integral part of the accounting system, of records of the batch totals of quantities, monetary amounts and any other information (including analyses) which has gone into the accounts from the documents comprising the batch.* These records are normally necessary for self-balancing procedures in mechanised systems and it would be difficult to over-estimate the importance of controlling by batches as the most effective way of breaking down voluminous documents into quantities which can safely be handled at one operation and which facilitate audit procedures. A simple example will illustrate the value of a sound batching system. A business which has sold goods during a month to 20,000 customers may require to record those sales so as to ascertain:

(i) the total sales;
(ii) the totals for each type of article;
(iii) the totals for each of twelve areas.

If the copy invoices are handled in 200 batches of 100 each, and the three types of analysis are made for each batch, then the batch record will not only provide the analysis totals required but will also enable other figures in the accounts to be verified (for example, those arising from posting to the personal ledger accounts of the 20,000 customers). If the auditor is satisfied that the system laid down is properly applied he can impose tests on selected batches in the knowledge that what he finds in those batches will be representative of the whole mass of sales records.

(*e*) *Sectional balancing of ledgers on the basis of the batch records suggested in (d) above.* This is a logical development of the batch system and will normally be required for the client's own purposes of control. The principles of sectional balancing are well known and it will be evident that the most satisfactory way of achieving this

form of control is to link the ledger sections with the batch records of prime documents.

Circumstances will arise in which the information required by the auditor, but not available because the client has dispensed with primary records, cannot be obtained from the normal accounting routine in the ways suggested above. Such cases may be due to the failure of the client to maintain an adequate control system, or to the desire of the auditor to impose an occasional test for which the material is not normally available. It then becomes necessary for the auditor to request the client to prepare special lists or analyses for audit purposes only. Where punched cards are in use special operations of this kind can often be undertaken after a considerable period has elapsed since the cards were first used, but it will usually be desirable for the auditor to make his requests promptly while the transactions are being recorded; for example, his request may be for proof sheets showing all postings made to a particular ledger during the day, or for a machine list of all the items in a particular selection of batches normally recorded in total only. It is necessary for the auditor to be careful and tactful in making such special requests, otherwise the object and scope of the proposed tests will be disclosed to the client's staff.

(2) *Cross-references*

Largely as a result of the direct posting system referred to under the previous heading, a possible source of considerable difficulty under a mechanised system may be the absence or inadequacy of cross-references between prime documents, primary records (day books or their equivalents) and secondary records (ledgers or their equivalents). The difficulties which can arise from this cause are mainly:

(*a*) In the analysis of nominal accounts; for example, items in the ledger may have no direct reference to the prime documents, such as invoices, from which they originated, a position which might arise where the invoices are filed under suppliers, the nominal totals having first been ascertained by calculating machine.

(*b*) In checking postings to personal accounts; for example, prime documents may be filed in batches without adequate references in the ledger to the batch numbers.

(*c*) In checking totals; for example, a tabulation of sales compiled from copy invoices may contain no reference numbers enabling the tabulation to be checked with the prime documents since filed under, say, areas or salesmen.

So far as secondary records are concerned, in the majority of systems they will normally be arranged in code number or alphabetical order, so that reference forward from prime documents or primary records may cause little or no difficulty. It is in connection with reference back from the secondary records that difficulties frequently present themselves un-

less an adequate cross-reference system is in force. For the auditor this presents a serious position, since the tendency in modern auditing practice is to substantiate the final records by breaking them down, rather than proof by building-up. The use of code numbers instead of names and narrative may aggravate the audit difficulties. On the other hand, code numbers can facilitate cross-reference if properly used and if the points dealt with below in the paragraph dealing with code numbers are observed.

Remedy

The only remedy for the above-mentioned difficulties is to institute an adequate cross-reference system so that the prime documents which support the entries in primary and secondary records are identifiable with reasonable speed and with certainty. This course should be recommended by the auditor in the client's own interests.

(3) *Code numbers*

Under any mechanised system, and inevitably with punched cards, code numbers will be used on an extensive scale to replace the names and descriptions which would be used under a normal manual system. The X. Co. Ltd. becomes number 7619; cash received is described in that account by, say, the code number 4, discount by code number 5, goods supplied by various code numbers according to type of goods and so on for all items. Similarly, lists of purchases may have been prepared, classified under types of atricle, by sorting punched cards under the code number appropriate to each type and tabulating accordingly. The machine list itself may reveal only the code numbers on which the cards were sorted. Moreover, a series of code numbers, say from 1 to 9, may be used on one column of a card for one series of items whilst another column, for an entirely different series of items, may also employ the numbers 1 to 9. In producing lists the machines themselves cannot show which particular column is involved on each list.

For the auditor the use of code numbers for descriptions is a matter of particular difficulty because his client will not usually experience the same troubles. The client's staff is accustomed to the meaning of the various code numbers since they are in daily use; whereas the auditor (for whom each business is only a small part of his practice and who is usually in contact with a particular system at infrequent intervals only) cannot hope to recognise all the code numbers with which he is confronted. The difficulties confronting the auditor are mainly:

(*a*) In checking personal accounts and nominal accounts, there being no effective narrative explaining the nature of the individual items posted.
(*b*) In analysing the content or nominal accounts where (as frequently happens) an account is not confined to items of an identical character.
(*c*) In examining machine lists where the nature of the content of the

lists is shown only by the code numbers; for example, sales may be listed under seven numbers representing types of goods but the machine list may show only the code number in each case.

Remedies

Code numbers are to a great extent one of the difficulties which the auditor is obliged to accept. They are necessary or particularly convenient to his clients and particularly inconvenient to himself. The difficulties can, however, be eased in the following ways:

(*a*) *Lists of code numbers and their meanings should be furnished to the auditor for his own use.* In most cases such lists will already exist for the clients' use; but if not their preparation for the auditor will benefit the client as well.

(*b*) *Wherever practicable code numbers should be translated into narrative form in making entries in nominal accounts.* This will usually carry advantages for the client both in the preparation of periodical accounts or financial statements and in reference back to accounts over a period of years.

(*c*) *Records for all standard transactions should be kept on specially designed stationery.* Thus, machine lists of items can easily be printed on paper having printed headings over the various columns in which code numbers appear. Similarly, sales invoices and copies thereof can be designed so that particular items appear in particular spaces and explanations of code numbers appear on the document itself. Devices of this kind will be regarded as essential for the business itself in any well-installed mechanised system.

If the recommendations in paragraph (1) above are adopted, the nature of the registers kept and the methods of filing documents will remove many of the auditor's difficulties in regard to code numbers in primary records.

(4) *Composition of ledger balances*

In all ledger accounts, but particularly in personal accounts, the absence of adequate correlation of debits and credits will cause considerable difficulty. If debit entries are not identified with the relative credit entries and *vice versa*, the current balance on an account may become incapable of analysis into the items of which it is composed, resulting in inability to prepare an accurate statement explaining the amount apparently outstanding. For the auditor the principal difficulties which arise are in connection with:

(*a*) Examination of the system of credit control. The task is rendered doubly difficult because the absence of proper correlation may indicate an ineffective credit control system; from which it follows that consideration by the auditor of the risk of loss through bad and

doubtful debts is a tedious and uncertain procedure.

(*b*) Verification of debtor and creditor balances as representing sums genuinely due to or by the client. This necessarily involves not only the possibility of error but also that of manipulation.

(*c*) Analyses of nominal accounts containing considerable transfer in and out.

Proper correlation is fundamental to any system of accounting (whether mechanised or not) and the absence of good ledger-keeping has often been a cause of difficulty in a purely manual system. But with mechanisation its importance is emphasised by the extensive use of code numbers and symbols instead of narrative and by the absence of manual balancing. A clerk posting to a handwritten ledger is more likely to clear debits with credits as part of his posting process than is a machine operator whose ledger is mechanically balanced (whether or not the entries are in the correct account) and therefore liable to be accepted as in order.

Remedies

Fortunately for the auditor, the available remedies are of even greater value to the client than to the auditor. Accounts, particularly personal accounts, kept in a slovenly manner will never improve operating efficiency and may, in extreme cases, result in serious financial loss through inability to support a dispute in a court of law. There are two remedies which should be recommended strongly to clients:

(*a*) *Where practicable and desirable, items posted to an account should be marked with a code or symbol indicating the relevant item (s) on the other side.*

(*b*) *The regular identification of the composition of outstanding balances should be part of the normal accounting system.*

In order to carry out the above suggestions special "query" and "credit control" staff should be employed, where the magnitude of the task warrants it, to keep the accounts under constant review. The need for this type of organisation is usually more apparent under a mechanised system because businesses dealing in large numbers of transactions are those most suitable for extensive mechanisation, whilst the reading of an account is rendered more difficult by the use of code numbers and of a running balance column.

(5) *Absence of ledger records*

It is the practice under some systems, not necessarily mechanised, to dispense with the traditional form of ledger account. This is done more frequently for purchases than for sales, payments to suppliers being authorised only on original invoices and precaution against duplicate payment being taken at the authorisation stage through the ordering system. In some cases no attempt is made to maintain records on a personal basis;

in others a quasi-ledger is maintained in the form of filed documents. The auditor's difficulty lies in the verification of balances due to and from the client.

Remedies

The remedies available are again all as much in the interests of the client as of the auditor:

(*a*) *The filing of original documents (or copies of documents sent out) as a quasi-ledger record in suitably designed binders or files.* Subsequent reference may become impossible if this is not done.

(*b*) *The maintenance of effective total accounts and other controls, rendering the individual items of secondary importance.* In this connection reference should be made to paragraph (1). Without an effective control system the discovery, tracing and correction of errors is difficult even with orthodox ledgers; it is virtually impossible where ledgers are abandoned.

(*c*) *The introduction of ledger accounts on orthodox principles where the complexity and value of the transactions are considerable.*

(6) *Misuse of accounting terms*

Some abuses of accounting terminology are found in practice in the operation of mechanised systems. It cannot be suggested that this gives serious difficulty to the experienced auditor, since he is concerned primarily with the principles of the system rather than the expressions used to describe the records and processes. For example:

(*a*) The expression "control account" is sometimes incorporated in the title of accounts which are not control accounts in the accepted sense of providing in total a counterpart to a number of individual accounts. "Control" is freely used in mechanised systems to indicate records which do no more than prove the accuracy of a mechanical operation.

(*b*) The expressions *"Dr."* and *"Cr."* are often applied to items or balances which under orthodox methods would be described by *"Cr."* or *"Dr."* respectively. This position arises because mechanisation is operated not on a "debit and credit" basis but on a "positive and negative" basis. A machine will frequently be operated without printing either *"Dr."* or *"Cr."* for the positive items (for example the debit balances in a list of sales ledger balances) but for the negative items (credit balances on the sales ledger) the machine may print *"Dr."* against those items if the use of that particular symbol is the easiest way of indicating the negative. It is obviously advantageous to run a machine in such a way that the normal items can be dealt with as positive, leaving only the exceptions to be distinguished as negative, even though in many instances this may result in credit items being described as *"Dr."*

Remedy

Much can be achieved through consultation with auditors when a mechanised system is installed, but no real remedy exists. Any unnecessary misuse of accounting terms may be remedied by appropriate recommendations from the auditor, but in general this question will gradually cease to have any practical importance as the use of mechanisation is extended and its peculiarities become commonplace or are overcome. The misuse of terms which now exists serves mainly to emphasise the importance to the auditor of a detailed explanation of the whole system and routine adopted by a particular client.

(7) *Incorrect allocations*

As indicated earlier, successful mechanisation depends on the grouping of transactions so that each group contains a large number of transactions requiring similar entries. Unfortunately it is found in practice that over-enthusiasm for the use of machines may result in their being used for tasks to which they are not really suited. This gives rise to a tendency to classify together transactions of fundamentally diverse types. A similar tendency results from inexperienced or incompetent supervision of the operation of a system that is sound in principle. For the auditor the serious difficulty, where large numbers of transactions are involved, is the risk of failure to detect incorrect allocations of material amounts resulting in improper description in the balance sheet and revenue account.

Remedies

To minimise the possibility of incorrect allocations attention should be directed to the two main principles involved:

(*a*) *Some transactions are not suited to mechanisation and they should be segregated and dealt with separately by manual methods rather than be forced into the system operated for the general run of normal transactions.* To attempt to force unsuitable items through by some deviation from the normal mechanical routine is undesirable and productive of error.

(*b*) *An adequate and effectively supervised system of classification and coding of prime documents is essential.* Whilst mechanisation provides a speedy and accurate method of passing transactions through the appropriate channels, it requires the highest degree of control over documents before the mechanical process is put into motion.

Where necessary the auditor should recommend to his client the adoption of any changes which the audit shows to be desirable in these respects.

The auditor will in any event need to apply various tests, as a normal part of his audit, to enable him to judge whether or not material errors of allocation are likely to exist. These tests lie mainly in the following directions:

(*a*) Exhaustive vouching of selected blocks of entries with the supporting prime documents to determine that transactions dealt with in a common manner are genuinely of one class.
(*b*) Exhaustive scrutiny of selected batches of prime documents to verify the coding.
(*c*) Detailed vouching direct from the ledger to the supporting prime documents in the case of the more material nominal accounts and all accounts (such as capital expenditure and repairs) which may contain "border-line" items.
(*d*) Scrutiny of all special entries.

The extent of the tests required will (as in all audit tests) be determined by the auditor's own opinion of the efficacy of the system.

Accounting by electronic methods is still in its infancy, and only some of the very largest companies have installed digital computers for ordinary accounting purposes. Few accountants, therefore, have yet been confronted with the task of auditing accounts produced by electronic means, and their number is unlikely to increase substantially during the next few years.

The Council of the Institute of Chartered Accountants in England and Wales have issued notes to their members on accounting by electronic methods and extracts from these notes are given below:

(1) "Electronic data processing" is the term applied to the method of analysing, marshalling, recording and reporting business information by means of equipment the central feature of which is an electronic digital computer. For convenience this method of processing business information is referred to in these notes as E.D.P.

(2) For processing to take place by means of E.D.P. the computer has to be given, in addition to the information to be processed, instructions directing it how to deal with the information; a sequence of such instructions is termed a programme.

(3) An electronic digital computer is a device capable of performing upon information, supplied to it in a suitable form, any arithmetical operation in accordance with predetermined instructions and of retaining in its store, for issue as required or for future use, the instructions, the original information and the results of its operation thereon. The instructions can be designed to produce not only the results of addition, substraction, multiplication and division but also the result of comparing, and thus of selecting between, two predetermined courses.

(4) The value of a computer for clerical and accounting work arises not only from the foregoing capabilities but also in particular from the speed in which it can execute its instructions coupled with a high

degree of automatic operation. In carrying out its instructions, the computer does not necessarily make any permanent or visible record of the individual intermediate steps taken. Thus, there is an apparent gap between prime and ultimate information, which is of particular significance to auditors.

(5) A computer operates by means of electronic switches which are internal parts of it and at any given moment are either "on" or "off". Thus, the circuits may be made to reflect one or other of two digits; it is this characteristic of the computer which has led to the binary scale of notation being commonly used for computers in place of the more usual decimal scale. Conversion to and from the binary scale is normally performed within the computer.

(6) Punched-card equipment can perform automatically the usual arithmetical processes, though normally only by recording intermediate steps on cards. Electronic calculators have been developed which can be used in conjunction with punched-card installations to speed up and extend the calculating processes and many punched-card installations now incorporate such a calculator. Such installations are sometimes referred to as "computers". Strictly speaking they are not computers because computers have the ability to:

(*a*) retain data and instructions within their own material store; and
(*b*) modify those stored instructions within the scope of the programme.

These notes deal only with installations containing, a computer.

(7) As already noted in paragraph (3) above it is necessary for information to be prepared in a form suitable for processing by the computer. This entails the preparation and coding of new information and conversion into input media, such as punched cards, punched paper tape, or magnetic tape. Thus, initial recording differs little from the established routines already commonly in use. For a computer, however, programmes must also be prepared, coded and recorded on suitable media.

(8) Thus, a large E.D.P. installation will normally consist of:

(*a*) input preparation units—for putting information on to punched cards, punched paper tape, or magnetic tape, in a form which the computer can absorb;
(*b*) input units—equipment by which the computer absorbs the information on the punched cards or tape;
(*c*) the processing unit—comprising arithmetic unit, control and internal store;
(*d*) output units—equipment enabling the computer to record the results of its work;
(*e*) external stores—with equipment for transferring information from the store to the processing unit and *vice versa;*
(*f*) output printing units—printers, card interpreters and typewriters, which are used to transcribe the results of the computer's work into a form in which it can be read.

(9) Most of the problems encountered by an auditor where E.D.P. is in use will be no different from those met where other forms of mechanised accounting are employed. The fact that an E.D.P. system is in operation makes no difference to the responsibilities of an auditor

(10) E.D.P. will not alter information appearing in ultimate records but may change radically the form of both intermediate and ultimate records and the means by which they are compiled. E.D.P. may also result in the elimination of intermediate records to an even greater extent than is possible with any mechanical system currently in use. Whilst it will remain possible for the auditor to verify accounts submitted to him and to examine the system of internal check, it may well be more difficult for him to do so. The method and techniques he may employ will require review.

(11) The provision of records essential for audit purposes will need to be taken specifically into account in devising and designing the E.D.P. system. Hence, it will be desirable that the auditor should be kept in touch with progress in designing the system and brought into consultation at the earliest possible stage so that his requirements may be known and provision made for them. From time to time changes will occur and as with other systems it will be desirable for the auditor to be consulted before any fundamental change is made. He will have to consider whether there is proper control over the use and amendment of programmes.

(12) As in any audit, the auditor will consider the adequacy of the system of internal check and in doing so will cover all sources of prime information and follow through to the stage at which information which has passed through E.D.P. becomes available for a report in conventional form. He will apply such tests as he considers necessary to satisfy himself that the system of internal check is operating efficiently. A mechanised (including E.D.P.) system of accounting usually affords the auditor a greater degree of assurance that the sample records tested by him are likely to be representative of the whole than is obtainable from a manual system.

(13) For audit purposes an auditor need not acquaint himself with the electrical or engineering details of the installation. He is essentially concerned to satisfy himself, by such audit tests as he may devise, that the procedures adopted have produced records which reflect adequately and correctly for accounting purposes the transactions which should have been recorded. For this purpose he may find that he has to bridge substantial gaps between documents or other records containing prime information and intermediate or ultimate records. In a mechanised system of any kind these gaps exist, as indeed they do in some manual systems. In E.D.P. it is likely that these gaps will be greater than in other systems and in consequence the maintenance of interim and control records becomes of greater importance for audit purposes. Provided the records kept are adequate and are suitably cross-referenced there should be no insuperable difficulty in tracing the connection between

an item in the accounts and the prime information from which it is derived.

(14) In addition to routine records produced in accordance with paragraph (11), the auditor may need to request the *ad hoc* production of information for audit purposes. Where assistance is sought in this way the auditor must exercise care so as to avoid premature disclosure of his requirements.

(15) The auditor will need to consider whether records are adequate for the purpose of the organisation as well as for the purpose of his audit. Wherever accounting is by methods other than manual methods there is a tendency to rely upon loose-leaf records, files of documents and records which although printed are in coded form. In considering such points it should be remembered that it may be necessary for the auditor to be in a position at a later stage to obtain information for special purposes, such as for a report to be set out in a prospectus.

CHAPTER IV

THE AUDIT OF THE IMPERSONAL LEDGER

§ 1. The Impersonal Ledger

In the two previous chapters, the duties of the auditor in relation to the examination of cash transactions and matters affecting the personal ledgers of a trading business have been considered, and it is now proposed to deal with the impersonal ledger, and the points that should be considered by the auditor in connection therewith. The verification of assets is a subject of great importance, and is dealt with in the succeeding chapter. Similarly, questions particularly affecting limited companies will more properly be considered in the chapters dealing with company audits. There remain, however, a large number of questions common to most classes of accounts, which particularly affect the ascertainment of profit or loss, and involve the consideration of important principles.

Ledger accounts may be divided primarily into two classes—

Personal and *Impersonal*

Personal accounts record dealings with persons, and, in the case of a trading business, consist principally of the accounts of persons from whom goods are bought, or to whom goods are sold, being recorded in the bought and sales ledgers respectively. There remain, however, a certain number of personal accounts which will be found in the impersonal ledger, such as Loan Accounts, Partners' Capital and Current Accounts, etc.

Impersonal accounts record the aspect of transactions as they affect the business, and not as they affect persons, and may be subdivided into *nominal accounts,* which relate to profit or loss, and *real accounts,* which record assets.

The impersonal ledger, therefore, should contain the whole of the accounts affecting the composition of the Trading and Profit and Loss Account, and all accounts representing assets and liabi-

lities, other than those contained in the personal ledgers. The term impersonal ledger is not always used; sometimes the term general ledger is employed, and in certain cases a nominal ledger will be found, which should only contain accounts relating to profit or loss. In most businesses a private ledger is utilised to contain accounts of an essentially private nature. Such variations of detail will be determined according to the convenience of each particular business, and the term impersonal ledger is here employed to cover all those accounts not included in the personal ledgers.

Except in very large businesses, the amount of detail in the impersonal ledger is not excessive, and the auditor will be able to check the whole of the entries therein. This is important, because, if the auditor is able to verify the correctness of the impersonal accounts, this fact in itself will go a long way towards proving the accuracy of the personal accounts, at any rate in total; one of the commonest methods of concealing manipulations in personal accounts being to make a corresponding fictitious entry in an impersonal account.

The entries in the impersonal ledger will come either from the totals of books of prime entry or their equivalents, the Journal, or from the Cash Book. The casts of the various books of prime entry or machine lists, having been verified, the totals thereof should be checked to the accounts in the impersonal ledger to which they relate. Where the totals have been subjected to analysis, the analysis should be cast and proved, and the individual items checked to their respective accounts in the impersonal ledger.

Many important transactions of an impersonal nature are recorded through the Journal. The vouching of such entries has already been dealt with, and when this is being performed by the auditor, he should see not only that there is sufficient evidence supporting the entry, but that the entry itself properly records the transaction. If this has been done, the actual checking from the Journal into the impersonal ledger becomes a matter of routine. In order to avoid a multiplicity of entries in the Journal, it is common to find many transactions recorded by means of a mere transfer from one account to another in the impersonal ledger. No serious objection can be taken to this practice where

the nature and reason for the transfer are apparent, but where transactions of an important or complicated nature have to be recorded direct transfers between accounts are to be deprecated. The auditor must examine and vouch direct transfers in the same manner as if they had been passed through the Journal. The postings from the Cash Book to the impersonal ledger should be tested exhaustively, as the auditor must satisfy himself, from the nature of the evidence available, that the accounts to which the items have been posted are the correct ones. Frequently, however, the particulars recorded in the Cash Book are insufficient to indicate the account to which the item should be posted. In such cases, when he examines the vouchers in support of the payments, the auditor should note against the entry sufficient particulars to enable him to assure himself, when the posting is checked, that the item has gone to the correct account. It will be appreciated that cash payments should be vouched before postings are checked.

Where the books are presented to the auditor balanced, and accounts have been prepared for submission to him, it is advisable that he should leave the examination of the impersonal ledger until the whole of the entries have been completed, the necessary adjustments made, and the accounts closed off. He can then check the balances direct to the Trading and Profit and Loss Account, the Balance Sheet and its schedules. In many cases, however, the auditor is called upon to act in the capacity of accountant, and make the necessary adjusting entries, draft the final accounts for submission to his clients, and close the impersonal ledger when these have been approved. Where this is so, the auditor will check the balances of the impersonal ledger to the Trial Balance that is produced to him, and utilise that as a basis from which to make the necessary adjusting entries and prepare the final accounts.

The distinction between an audit and accountancy work has already been referred to in Chapter I, and need not again be discussed here; but whether the auditor makes the adjusting and closing entries, or merely audits them, he must satisfy himself that those entries are correct, and that all the necessary adjustments, of which he has knowledge, have been made.

§ 2. Outstanding Liabilities and Assets

In a business of any size, there is always a considerable number of adjustments to be made at each balancing period, for the purpose of properly recording outstanding liabilities and assets, which for some reason or other have not already been brought into the accounts. Adequate schedules of such outstandings should be prepared and these will form the basis of the adjusting entries to be made.

The normal practice is to bring an outstanding liability down as a credit balance on the impersonal account concerned and in a similar manner to bring an outstanding asset down as a debit balance. Care should be taken to see that such balances are treated as liabilities and assets respectively in the preparation of the Balance Sheet. The auditor should compare the items on the Schedules of outstandings with the corresponding schedules for the previous year and satisfy himself as to the reasons for any material differences. It is also essential that the auditor should ensure that the outstandings brought forward at the beginning of the year have been cleared during the year. A liability for which provision was made, or an amount recoverable brought down at the end of the previous year, may still remain unsettled and if attention is not paid to this point, the balance on the relevant impersonal account for the year under review will be inflated or deflated if the item is not again carried forward.

(A) Outstanding Liabilities

The inclusion of all known liabilities in the accounts is of great importance, inasmuch as it directly affects the correctness of the Profit and Loss Account and/or the Balance Sheet. It is, therefore, one of the duties of the auditor to ascertain that all outstanding liabilities are dealt with. This is not always an easy matter, as a liability may be suppressed or concealed and the books and vouchers may contain no indication of its existence. There are, however, certain classes of outstanding liabilities which are common to most businesses, and the existence of which, though not recorded in the books, should be apparent to the auditor from the nature of the transactions. The existence of other liabilities, though not so apparent, may be suggested to the auditor by his experience. The more usual of these will now be dealt

with.

(1) *Purchases*

In some instances invoices relating to purchases of goods that have been taken into stock are received too late to be included in the Purchases Day Book, if any, before the accounts are closed, and may consequently have been entered in the succeeding period. A schedule of these should be prepared, and the total debited to the Purchases Account, and carried down as an outstanding liability. Where the precise amount of the liability cannot be ascertained, an estimate should be made by some responsible official.

(2) *Wages*

In the case of a manufacturing business, where the date of the Balance Sheet happens to fall in the middle of the month, the proportion of wages accrued should be calculated and brought in as a liability.

(3) *Rent, Rates, etc.*

It should be seen that all rents which are payable in arrear have either been paid to the last due date, or that the outstanding rent is brought in as a liability. Where the date on which the accounts are closed falls between the dates at which the rent is payable, the rent accrued to date must also be calculated and brought into account. The same remark applies to rates, though, as these are usually payable in advance, the adjustment necessary will be to carry forward the prepayment as an outstanding asset, as will also be the case with rents payable in advance.

(4) *Freight*

Carriage and freight accounts may not be rendered till some time after the period to which they relate, and it is often necessary to close the accounts before they are received. In such a case, the amount outstanding must be estimated, and a comparison with the corresponding items of the previous year will afford a useful indication of the probable amount outstanding, if the business is of a regular nature. Payments for freight are usually posted direct to the impersonal account, and the auditor should be able to ascertain, from his examination of the freight account, the period

in respect of which any liability is outstanding.

(5) *General Expenses*

A schedule of the expenses outstanding should be prepared, and the total brought down as a liability on the General Expenses Account. It will be found, usually, that certain classes of expenditure are outstanding, particularly where no personal accounts are kept for the creditors concerned.

(6) *Legal Expenses*

Solicitors often allow some time to elapse before sending in accounts to their clients, and consequently legal expenses may be outstanding, which should be provided for. Where no account has been received from the solicitor, an estimate of the amount of his costs up to the date of the Balance Sheet should be obtained from him.

(7) *Audit Fee*

The question as to whether the audit fee relating to the period covered by the accounts should be brought in as a liability at the date of the Balance Sheet has been much discussed, and still remains an open point. In some cases the audit may not have been commenced till after the date at which the accounts were closed, in which event it cannot properly be said to be a liability at the date of the Balance Sheet. In any event only a part of the work will have been performed. On the other hand, the work involved relates to the period covered by the accounts, and it is certainly advisable that the audit fee should be treated as an outstanding liability. Similar remarks apply to accountancy charges for the preparation of the accounts, etc. In cases where the fee has not yet been agreed, but is dependent on the amount of work involved, an estimated amount should be brought in as outstanding.

(8) *Travelling Expenses*

A schedule should be compiled of all travelling expenses due to travellers and others up to the date of the Balance Sheet, and these can be verified by the auditor, since they will probably have been paid early in the succeeding period.

(9) *Travellers' Commission*

The Travellers' Commission Account in the impersonal ledger should be examined and tested with the commission statements relating to each traveller. It will be found, usually, that the commissions in respect of sales for the closing month of the period will not have been paid till the succeeding month, and the amounts due must therefore be brought in as outstanding. If any sums have been paid to individual travellers on account, only the balance of the commission due should be brought into account. Sometimes it is found that the advances exceed the amount of commission payable, and in that case the excess of the amount advanced over the amount due is in effect a loan, and should be brought down as an outstanding asset, and treated in the Balance Sheet as a debtor, provision being made where necessary for any doubtful debts.

In some cases a traveller is not paid commission until the goods ordered through his agency have been paid for; in other cases only part of the commission is paid on execution of the order, and the balance when the goods are paid for. Where arrangements of this nature are in force, the auditor should ascertain that proper provision has been made for outstanding commissions that will become payable in respect of goods sold prior to the date of the Balance Sheet.

Sometimes the arrangement with the traveller provides that returns, allowances, and bad debts in respect of orders upon which commission has already been paid are to be brought into account in arriving at the current commission. If this is so, the auditor should ascertain that the proper deductions have been made.

(10) *Interest on Loans*

All interest due or accrued should be calculated at the proper rate, and brought in as an outstanding liability.

(11) *Taxation*

In case of firms registered under the Income Tax Act, the firm's profits are liable to the Income Tax leviable on registered firms, if the firm's income exceeds the prescribed limit. In such cases, the firm's total income should be computed and provision made for the tax liability of the firm itself. Similarly, where the firm

is an unregistered firm, which is not likely to be treated as a registered firm, the firm's total income should be computed and provision made for the tax liability on the firm's profits.

When the exact liability is ascertained the auditor must take care to see that the correct adjustments have been made to the provision for taxation account, if the provision is found to be in excess or short of the actual liability. As regards the tax liability of partners, their current accounts will be debited when their tax liability is discharged through the firm. Unless the auditor deals with the personal taxation affairs of each partner he will not be able to test the accuracy of such payments. In such cases he must obtain confirmation from each partner as to the accuracy of the charge made to his account for his taxes paid by the firm.

It should be noted that tax liability of a partner who is non-resident or a partner who is residing in Pakistan at the time of assessment, is payable by the firm and hence it should be seen that such a partner retains sufficient profit in the firm to enable it to meet his tax liabilities when they fall due.

It will usually be found that no provision for income tax is made in the accounts of a sole trader. When, however, the tax payable is considerable it is suggested that the auditor should recommend to his client that provision be made for the estimated liability in order that the trader shall be in no doubt as to his future financial commitments.

The question of providing for income tax and super tax liabilities in the accounts of companies is a matter of considerable importance and is dealt with in Chapter X.

(12) *Contingent Liabilities*

The auditor should ascertain whether there are any transactions outstanding at the date of the Balance Sheet which might involve the payment of money at some subsequent date. Such outstandings are termed "Contingent Liabilities," and may be of two classes: the one involving a loss should the liability accrue, and the other the acquisition of an asset of corresponding value.

It is sufficient for the amount of the contingent liability to be stated on the face of the Balance Sheet by way of a note, unless there is a definite probability that a loss will materialise. when specific provision should be made therefor. The most familiar ins-

tance is the contingent liability on bills receivable discounted. If at the date of the Balance Sheet any of the bills that have been discounted are outstanding, there will be a contingent liability in respect thereof, since, if the acceptors do not meet the bills at maturity, the holders will have a right of recourse against the drawer or any prior indorser. As it may not be known at the date of the Balance Sheet whether all these bills will be met, a note of the amount of the contingent liability must be appended. Where, however, it is anticipated that any bills will be dishonoured, and that a loss will subsequently be incurred, provision should be made accordingly. In many cases, by the time the audit is completed some of the bills will have matured, and it will be only in respect of those still outstanding that the auditor should consider the advisability of a provision being made.

Other instances of contingent liabilities which might involve a loss, should they accrue, would be damages and costs in the case of an action pending, forward contracts, guarantees for third parties, and speculative transactions open on the Stock Exchange. The last-mentioned will be considered in Chapter XIV.

In cases where, should a liability accrue, it will involve the acquisition of a corresponding asset, it is usual to make no reference thereto on the Balance Sheet. Instances of this are contingent liabilities under trade contracts, or under agreements for service, though where the amount involved is considerable, it is advisable to note it. The contingent liability in respect of shares partly called up, held by way of investment, must be disclosed. In the case of companies, the Companies Act, 1956, requires that the estimated amount of contracts for capital expenditure not provided for in the accounts, should be shown as a footnote to the Balance Sheet.

(B) Outstanding Assets

There are two classes of outstanding assets which may require to be dealt with: firstly, items accruing or due, not recorded in the books, which will ultimately be received in cash; and, secondly, expenditure already incurred, some portion or the whole of which relates to a period subsequent to the date of the Balance Sheet. Items coming within the latter class are usually named *payments in advance* or *prepayments* and should be shown in the

Balance Sheet in one total under such a heading. In order that the profit or loss may be correctly stated, it is important that on the one hand only expenditure relating to the period under review is included, and that on the other hand all income accruing, that is reasonably certain to be received, is brought into account.

Expenditure which is not strictly apportionable in respect of time, but the benefit of which has not been entirely received during the period under review, may in many cases be properly carried forward in suspense, and written off over a period of years. The treatment of such items will be dealt with in § 4.

The following are the more usual classes of outstanding assets:

(1) *Rents Receivable*

All rents receivable due or accrued to the date of the Balance Sheet should be calculated and brought into account, provision being made for doubtful or irrecoverable arrears, allowances for repairs, etc.

(2) *Interest and Dividends*

Interest receivable on loans accrued to the date of the Balance Sheet should be brought into account in all cases where the interest is regularly paid on the due dates. If the interest is in arrear, the amount accrued should either be omitted, or brought into account, and a corresponding provision made against it. Interest on debentures and other securities, which it is known will be received in due course, may be calculated and brought into account, in-so-far as they have accrued at the date of the Balance Sheet. Dividends on shares will normally be taken to be the income of the period during which the date of declaration falls.

(3) *Commission Receivable*

Commissions due or accrued should be brought into account, but before passing the item the auditor should examine the basis on which the calculation is made, and satisfy himself that the amount will be duly received.

(4) *Rents, Rates, etc., paid in Advance*

Rent is sometimes payable in advance, and the amount so paid relating to the period subsequent to the date of the Balance Sheet

should be carried forward. Rates, etc., are usually payable in advance, and where paid prior to the date of the Balance Sheet, similar considerations apply. The auditor should examine the demand notes to ascertain the period to which the rates, etc., apply.

(5) *Insurance Paid in Advance*

Insurance is payable in advance, and in the case of a large business the premiums payable may be considerable. The proportion thereof applicable to the period subsequent to the date of the Balance Sheet should be calculated, and brought down as an outstanding asset. The last premium receipts will have been inspected in the course of vouching, and the auditor should refer to the actual policies if he considers it desirable.

Certain types of insurance, *e.g.*, floating stock policies, block policies, etc., require a premium adjustment at the end of the year and care must, therefore, be taken to see that provision is made for any liability or amount recoverable.

(6) *Advertising*

Payments are frequently made in advance under advertising contracts, and the proportion thereof relating to any period subsequent to the date of the Balance Sheet should be carried forward. Stock of advertising material, such as posters, signs, samples, etc., if not obsolete, may be valued at or under cost, and carried forward as an asset, depreciation, where necessary, being allowed for. This subject is further considered in § 4(B).

§ 3. Apportionment of Expenditure between Capital and Revenue

The distinction between capital and revenue is of vital importance as it affects the amount of profit or loss, and the correctness of the Balance Sheet.

Capital Expenditure may be said to be all expenditure incurred for the purpose of acquiring, extending or improving assets of a permanent nature, by means of which to carry on the business, or for the purpose of increasing the earning capacity of the business.

Revenue Expenditure is all expenditure incurred in carrying

on the business, and in maintaining the capital assets in a state of efficiency.

The allocation of expenditure as between capital and revenue calls for the auditor's careful examination. Where the expenditure is directly incurred for capital purposes, it can be vouched by the auditor in the course of his examination of the Cash Book, or relevant Day Book, and his duties in this connection have already been dealt with. In many cases, however, the expenditure takes the form of wages of the firm's own workmen, either wholly or partially employed on capital improvements and extensions, whose wages are included in the general Wages Account. Unless, therefore, a transfer is made from the Wages Account to the debit of the asset account concerned, revenue will be charged with wages which may properly be capitalised. Before passing any such transfer the auditor should examine the basis upon which it has been calculated. In these cases general estimates are unreliable and insufficient; precise particular should be furnished of the number of men employed, the nature of their work, rates of pay, etc., and the proportion thereof applicable to capital. Such an analysis should be certified by the wages clerk as to calculations, and by the foreman as to the work done and the nature thereof, and finally by the works manager as being correct, and properly chargeable against capital. Expenditure in the shape of wages on repairs or renewals should be charged to the Repairs and Renewals Account, and not left in Wages Account.

Similar considerations apply to expenditure on materials which cannot be directly allocated to capital purposes at the time of purchase. Schedules of all goods taken from store for such purposes should be prepared by the storeskeeper and certified by the works manager, the values being calculated at cost price.

Where obsolete plant is replaced it is prudent to write off the cost of dismantling the old plant although this could be considered to be part of the total expenditure on the new installation.

§ 4. Deferred Revenue Expenditure

Reference has already been made to certain classes of expenditure which are primarily of a revenue nature but the benefit of which is not exhausted during the period covered by the Profit and Loss Account. Such expenditure may be conveniently term-

ed *deferred revenue expenditure,* and may be carried forward and written off within the period likely to benefit from it, in order to avoid un unduly heavy charge being made against the profits of any one year.

Where it is proposed to carry forward expenditure of this nature, the auditor should enquire into all the facts of the case before he passes this treatment, since it could be resorted to for the sole purpose of inflating profits.

The following are examples of expenditure which can be carried forward in this manner.

(A) Alterations to Plant

Heavy expenditure may be incurred for the purpose of improving plant and machinery, or in adapting it to altered conditions of trade. Whilst the bulk of such expenditure may be regarded as capital expenditure a proportion may in fact represent repairs and must be written off. If the expenditure on repairs is unduly heavy it may be carried forward, and written off over a short period of years, where no provision for future repairs exists against which it may be debited. The nature of the expenditure should be clearly stated in the Balance Sheet, and, if necessary, the auditor should draw attention to the treatment of it in his report.

Similar considerations may apply in the case of heavy renewals occasioned by scrapping obsolete plant.

(B) Advertising

Abnormally heavy expenditure on advertising is frequently incurred in the course of establishing a new business. Where such expenditure is on a large scale, it is in fact a form of capital expenditure, and may actually be capitalised under the heading of development expenditure or advertising goodwill. Goodwill of this nature, however, cannot be maintained unless considerable advertising is continued in subsequent years, and a certain proportion should therefore be written off to the Profit and Loss Account. The balance may be carried forward permanently as an asset, though it is preferable to write it off over a period.

Where the expenditure on advertising is not incurred for the purpose of creating an entirely new business, but is nevertheless

of an abnormal nature owing to the marketing of a new product or the opening of a new department, the average annual charge for advertising should be estimated, and such amount written off to Profit and Loss Account, the balance being carried forward and shown separately in the Balance Sheet as advertising suspense. The auditor should ascertain that the amount so written off is adequate, and that the Suspense Account is not carried forward over an unreasonable length of time.

Similar considerations apply to businesses where the advertising is not continuous, but heavy expenditure is incurred from time to time. In seasonal trades, expenditure may be made in connection with a new season, the benefit of which may not be felt before the accounts are closed. In such cases a proper proportion of the expenditure may be carried forward.

(c) Preliminary Expenditure in connection with a new Business

Heavy preliminary expenditure may be incurred in connection with the commencement of a business, or the institution of a new department, before it can reach a revenue-earning stage. Such expenditure may take the form of rent, rates, salaries, wages and general charges; and in order to avoid unduly burdening the Profit and Loss Account of the first period, it may properly be carried forward, and written off over a short period of years. In such a case the auditor should ascertain that all current expenditure incurred after the revenue-earning stage has been reached is charged to the Profit and Loss Account.

§ 5. The Valuation of Assets

It may be convenient here to indicate the general principles which should be applied to the valuation of assets in a Balance Sheet. The legal aspect of the subject as affecting limited companies will be dealt with in Chapter XI.

(a) Fixed Assets

Fixed Assets are those of a permanent nature, by means of which the business is carried on, and which are held for the purpose of earning income, and not for the purpose of sale, *e.g.*, land, buildings, plant and machinery, etc.

Such assets are shown in the Balance Sheet at cost and the total of the provisions made to date for depreciation shown as a deduction therefrom. Depreciation is normally calculated on such a basis as will spread the expenditure equitably over the effective lifetime of the assets, so that the Profit and Loss Account of each accounting period may be charged with the proper proportion of the cost.

The changes which have taken place in recent years in the purchasing power of money, however, have resulted in:

(*a*) fixed assets appearing in Balance Sheets at values far below their current replacement values, and

(*b*) where depreciation has been provided on such book values, profits being distorted because turnover is in terms of depreciated rupees, and

(*c*) inadequate amounts being accumulated out of profits for replacement.

The result of (*a*) is that shareholders do not obtain a true picture of the present value of the assets of the companies in which they have invested their money, whilst as a result of (*b*) they do not appreciate that when fixed assets have to be replaced, much higher depreciation charges will follow and that, as a consequence, profits will be reduced.

It is sometimes contended, therefore, that fixed assets should be written up to their current values, capital reserve being credited with the surplus, and that depreciation should be provided on such amended values. These suggestions have received the serious attention of the professional accountancy bodies and extracts from their pronouncements on the subject are reproduced below:

The Institute of Chartered Accountants in England and Wales

The Council cannot emphasize too strongly that the significance of accounts prepared on the basis of historical cost is subject to limitations, not the least of which is that monetary unit in which the accounts are prepared is not a stable unit of measurement. In consequence the results shown by accounts prepared on the basis of historical cost are not a measure of increase or decrease in wealth in terms of purchasing power; nor do the results necessarily represent the amount which can prudently be regarded as available for distribution, having regard to the financial requirements of the business. Similarly the results shown by such ac-

counts are not necessarily suitable for purposes such as price fixing, wage negotiations and taxation, unless in using them for these purposes due regard is paid to the amount of profit which has been retained in the business for its maintenance.

On the other hand the alternatives to historical cost which have so far been suggested appear to have serious defects and their logical application would raise social and economic issues going far beyond the realm of accountancy. The Council is therefore unable to regard any of the suggestions so far made as being acceptable to the existing accounting principles based on historical cost.

Unless and until a practicable and generally acceptable alternative is available, the Council recommends that the accounting principles set out below should continue to be applied:

(*a*) Historical cost should continue to be the basis on which annual accounts should be prepared and, in consequence, the basis on which profits shown by such accounts are computed.

(*b*) Any amount set aside out of profits in recognition of the effects which changes in the purchasing power of money have had on the affairs of the business (including any amount to finance the increase in the cost of replacements, whether of fixed or current assets) should be treated as a transfer to reserve and not as a charge in arriving at profits. If such a transfer is shown in the profit and loss account as a deduction in arriving at the balance for the year, that balance should be described appropriately, since it is not the whole of the profits.

(*c*) In order to emphasize that as a matter of prudence the amount so set aside is, for the time being, regarded by directors as not available for distribution, it should normally be treated as a capital reserve.

(*d*) For balance sheet purposes fixed assets should not be written up, especially in the absence of monetary stability.

The Council also recommends to members who are directors or officers of companies or who are asked by clients for advice, that they should stress the limitations on the significance of profits computed on the basis of historical cost in periods of material changes in the purchasing power of money; and that they should draw attention to the desirability of:

(*a*) Setting amounts aside from profits to reserve in recognition of the effects which changes in the purchasing power of money have had upon the affairs of the business, particularly their effect on the amount of profit which, as a matter of policy, can prudently be regarded as available for distribution.

(*b*) Showing in the directors' report or otherwise the effects which changes in the purchasing power of money have had on the affairs of the business, including in particular the financial requirements for its maintenance and the directors' policy for meeting those requirements, either by setting aside to reserve or by raising new capital.

(*c*) Experimenting with methods of measuring the effects of changes in the purchasing power of money on profits and on financial requirements. If the results of such experiments are published as part of the documents accompanying the annual accounts, the basis used for the calculations and the significance of the figures in relation to the business concerned should be stated clearly.

The Association of Certified and Corporate Accountants

In dealing with depreciation we must for the sake of clarity and simplicity define the nature and purpose of depreciation.

For our purpose we take depreciation in the narrower sense as the diminution in value which a physical asset suffers through use and the effect of time and which cannot be made good by maintenance. We leave out of account the wider interpretation of depreciation which includes the loss of value of assets due also to changes in economic conditions, such as changes in consuming habits or methods and techniques of production, which is compendiously termed obsolescence. For present purposes we define depreciation in the narrower sense as the consumption of utility value spread over the life of the asset, which cannot be recovered by maintenance. The essence of this definition is that it is not dependent on replacement, although the measure of value that has been consumed can only be correctly ascertained by reference to the current cost of replacement. The physical deterioration of an asset is an expense incurred now, during the current accounting period, whether this asset will or will not be replaced at a later date. The purpose of the depreciation charge is not to provide for a fund for replacing the asset (although that may be its incidental and useful result) but for accounting as an expense the cost of using it up. Depreciation is first and foremost the recovery, spread over the life of the asset, of the prepaid cost incurred by its acquisition.

An annual charge which will do this is the minimum that must be charged against current operations during the useful life of the asset. But if—owing to the inflationary rise in prices—this charge is lower than it would be if it were calculated on the same cost basis as other items of expenditure, e.g., maintenance and repair, then expenses are understated and profits overstated. To remedy this the depreciation charge can be divided in two parts.

(*a*) the basic charge, calculated on recorded cost and designed to recover it over the useful life of the asset; and
(*b*) a supplementary charge for the difference by which the basic charge falls short of the amount which would appear as an expense if it were calculated on a basis homogeneous with maintenance, repair and other current expenses.

The practical application of this convention would not create great technical difficulties, nor would it cause a breach in the structure of ac-

counting principles. In fact, the whole system of accounts would remain unchanged, up to and including the trading or manufacturing account, where the basic depreciation would be accounted for. The balance—the trading profit—could be brought to a depreciation adjustment account where the supplementary depreciation could be charged. The balance would be carried to the profit and loss account. The basic depreciation would continue to be deducted from the book value of the assets in the balance sheet and the supplementary depreciation brought to a special replacement provision account.

It must be admitted that the choice of the co-efficient to be used for measuring the trend in the purchasing power of money as regards its application to the current value of fixed assets presents some difficulty, for there does not appear to be available an index of prices which is closely suitable. The cost-of-living index has the advantage that it is official and is perhaps the nearest approach towards measuring the *general* trend of the purchasing power of money, but it is doubtful whether it is satisfactory for the purpose of fixed assets. Here, it seems, a more specialized index, more heavily weighted for fluctuations of wholesale prices of raw materials and for movements in wages, would be more satisfactory. No such comprehensive *or* official index appears to exist.

It will thus be seen that it is generally accepted that the provision for depreciation should continue to be made on the basis of historical cost, but that where it is anticipated that the cost of replacing a fixed asset will be greatly in excess of its original cost an additional amount should be set aside to provide the further funds which eventually will be required for replacement.

(B) WASTING ASSETS

Wasting assets are those of a fixed nature which are gradually consumed or exhausted in the process of earning income, *e.g.*, a mine, quarry, etc.

It will be seen that wasting assets are in effect a sub-division of fixed assets, but include only those which decrease in value through the operation of being worked, and therefore are not subject to depreciation through wear and tear.

The question as to the value at which wasting assets should appear in the Balance Sheets of limited companies is particularly important and involves legal considerations which are considered in Chapter XI.

From a general point of view, it may be remarked here that in order to replace the exhausted capital out of revenue it is neces-

sary to reduce the book value of the wasting asset to the extent of the estimated amount by which it has diminished in value.

(c) Current Assets

Current assets are those in which the business deals, and which are acquired for the purpose of sale, and the subsequent stages of their conversion into cash, *e.g.*, stock, book debts, cash, etc.

The valuation of current assets should be at cost or market price, whichever is the lower at the date of the Balance Sheet. The object of the business being to convert current assets into cash, and to make a profit from dealing in them, it becomes a point of the utmost importance that the valuation placed on these assets at the date of the Balance Sheet shall be such that any loss sustained in connection therewith is taken into account.

§ 6. Depreciation

(a) General Considerations

One of the most important points which an auditor has to consider is whether sufficient provision has been made in the accounts for depreciation.

Depreciation may be defined as the measure of the exhaustion of the effective life of an asset from any cause during a given period. If an asset has been acquired for the purpose of being utilised to earn income, and in the course of such process it becomes worn out or obsolete, such expired capital outlay is a loss which should be set off against the income derived from working the asset, before the balance of divisible profit can be ascertained. If this is not done, the Profit and Loss Account will not show the correct profit for the period, and the Balance Sheet cannot be said to represent a true and correct view of the state of the affairs of the business, inasmuch as the assets will remain at their original value, notwithstanding the fact that depreciation has taken place.

Where objection is taken by clients to the proper provision for depreciation, and the auditor advances theoretical arguments in support of his view, these do not always receive sufficient consideration, owing to the fact that the practical bearing of the question of depreciation upon the financial position of the business is not sufficiently emphasised. It cannot be too strongly pointed

out that if the whole of the profits of a business are withdrawn without providing for the loss arising through depreciation, no funds will be accumulated out of revenue during the life of the asset for the purpose of replacement. When such replacement becomes necessary, fresh capital will have to be provided for the purpose.

In this connection it may be remarked that where large sums will be required at some subsequent period for the renewal of assets, it may be advisable for the funds provided out of revenue to be invested outside the business, in order that they may be readily available. If the amount so set aside is left in the business, it will in due course form part of the working capital, and may be locked up in stock or other assets which may not be capable of ready realisation when it is necessary for the replacement to be made.

Before the auditor can satisfy himself that the provision made for depreciation is adequate, he must have some knowledge of the considerations which are necessary to determine the rate of depreciation in connection with any particular class of asset.

Depreciation may be said to arise from two causes—internal and external. Internal depreciation is that arising from the operation of any cause natural to, or inherent in, the asset itself, *e.g.*, wear and tear in the case of plant and machinery. External depreciation is that arising from the operation of forces outside the asset itself, *e.g.*, obsolescence in the case of plant; effluxion of time in the case of a lease.

In order to fix the rate of depreciation, the effective life of the asset must be determined or estimated, and before this can be done the various forms of depreciation to which it may be subject should be considered. It is usually possible, given some knowledge and experience of the business concerned, to estimate the rate of internal depreciation, such as wear and tear, with reasonable accuracy. The loss occasioned by effluxion of time can be calculated exactly, but other forms of external depreciation are often so variable that the amount cannot be estimated accurately, and consequently complete provision is not usually made until the actual loss occasioned thereby has arisen.

The term "depreciation" should not be confused with "fluctuation," which connotes *temporary* change in realisable value, quite

distinct from depreciation of a permanent character.

Where the auditor is of opinion that insufficient provision has been made for depreciation, and he is unable to induce his clients to adopt his point of view, he *must* deal with the matter in his report.

In considering the basis of the provision for depreciation, it should be remembered that in the course of years, conditions may alter materially, and thus affect the accuracy of the original calculations. It is, therefore, advisable that the rates should be reconsidered from time to time.

(B) The principal methods of providing for the Depreciation of different classes of Assets

The following are the principal methods of providing for depreciation, where it is desired that the amount set aside should be accumulated *in the business*:

The Fixed Instalment System, or "Straight Line" method whereby a *fixed* rate per cent. on the original cost of the asset is set aside each year. This is the most suitable method for general application.

The Reducing Instalment System, whereby a fixed rate per cent. on the *diminishing* value of the asset is set aside each year.

The Annuity System, whereby the asset is regarded as earning a certain rate of interest, and such fixed amount is provided for depreciation each year as, after debiting the asset account with interest at a fixed rate per cent. upon the diminishing value, will equal the amount at which the asset plus the interest added to the original cost stands in the books at the end of its life.

Where it is desirable to accumulate funds *outside the business*, the following are the principal methods utilised:

The Depreciation Fund System whereby an equal amount is debited to the Profit and Loss Account each year, and credited to a Depreciation Fund Account, and an equivalent amount of cash is *invested outside the business*. The investment is usually made in a fixed interest bearing security with a redemption date as near as possible to the date on which the funds will be required and the interest received will be reinvested.

The Insurance Policy System whereby an endowment Policy is taken out for the life of the asset, so as to produce the

amount required at the end of the particular period.

In cases where the nature of the asset renders it difficult to provide for depreciation on a mathematical basis, REVALUATION should be resorted to. In this case, the asset will be revalued each year and the loss disclosed on book value written off to revenue.

THE DEPLETION UNIT SYSTEM, applicable to wasting assets such as mines and quarries, whereby such a sum is set aside each year out of profits as represents the expired capital outlay, on the basis of a comparison of the amount of the produce extracted during the period with the estimated total workable deposits of the mine, etc.

THE MACHINE HOUR SYSTEM. Under this system, the estimated total number of working hours of a machine during the whole of its effective life is divided into the cost of the machine to arrive at an hourly rate of depreciation. The Profit and Loss Account of each period is then charged with depreciation, calculated at the hourly rate, for the number of hours during which the machine has been worked during the period.

The recommendations of the Council of the Institute of Chartered Accountants in England & Wales on the subject of depreciation are reproduced hereunder.

Fixed assets, whatever be their nature or the type of business in which they are employed, have the fundamental characteristic that they are held with the object of earning revenue and not for the purpose of sale, in the ordinary course of business. The amount at which they are shown in the balance sheet does not purport to be their realisable value or their replacement value, but is normally an historical record of their cost less amounts provided in respect of depreciation, amortisation or depletion.

Depreciation represents that part of the cost of a fixed asset to its owner which is not recoverable when the asset is finally put out of use by him. Provision against this loss of capital is an integral cost of conducting the business during the effective commercial life of the asset and is not dependent upon the amount of profit earned.

The assessment of depreciation involves the consideration of three factors: the cost of the asset, which is known, the probable value realisable on ultimate disposal, which can generally be estimated only within fairly wide limits, and the length of time during which the asset will be commercially useful to the undertaking. In most cases, this last factor is not susceptible of precise calculation. Provisions for depreciation are therefore in most cases matters of estimation, based upon the available experience and knowledge, rather than of accurate determination. They re-

quire adjustments from time to time in the light of changes in experience and knowledge, including prolongation of useful life due to exceptional maintenance expenditure, curtailment due to excessive use, or obsolescence not allowed for in the original estimate of the commercially useful life of the asset.

There are several methods of apportioning depreciation as between the several financial periods which constitute the anticipated useful life of the asset. Those most commonly employed in industrial and commercial concerns in this country are the straight-line method and the reducing balance method.

Subject to any periodic adjustment which may be necessary, the straight-line method (computed by providing each year a fixed proportion of the cost of the asset) spreads the provision equally over the period of anticipated use. It is used almost universally in the United States of America and Canada and to a large extent in this country. Though other methods may be appropriate in the case of some classes of assets, the balance of informed opinion now favours the straight-line method as being the most suitable for general application.

The reducing balance method, which spreads the provision by annual instalments of diminishing amount computed by taking a fixed percentage of the book value of the assets as reduced by previous provisions, is also largely used in this country. It involves relatively heavy charges in the earlier years of the life of an asset and relatively light charges in the later years. In order to provide depreciation under this method within any given period, the percentage applied needs to be from two to three times that applied under the straight-line method. This is a fact not generally realised, the consequence being that rates of depreciation fixed on this basis may tend to be inadequate.

A third method, known as the sinking fund method, which endeavours to take account of anticipated income from funds set aside for depreciation purposes, is not used to any great extent in industrial and commercial concerns, though in public utility undertakings, where special considerations arise, it is frequently met. Under this method, fixed annual instalments are provided and set aside, which with compound interest, will accumulate to the cost of the asset by the end of its useful life. Where the amounts set aside are invested outside the business, the validity of the calculations depends upon the realisation of the anticipated net rate of interest, and each change in tax rates or interest involves recalculation. Where the amounts are retained as additional working capital, the effect is to make a growing charge in the periodic accounts for depreciation, because the fixed periodic instalment has to be supplemented in each period by an amount equivalent to interest on past provisions. Experience shows that, with the uncertainties inescapable in industrial and commercial enterprises, it is not prudent to place reliance upon the accrual of additional earnings to the extent required.

A fourth method, also not commonly used in industrial and commercial concerns, is the renewals reserve method, under which round sums,

not necessarily computed by reference to the useful lives of the assets, and sometimes detemined largely by the results of the year's trading, are provided and set aside as general provisions towards meeting the cost of future renewals. This method does not accord with a strict view of depreciation and may distort the annual charges to revenue.

The different natures of assets involve consideration in deciding on the method of depreciation appropriate in each case. Unless the methods adopted are applied consistently the usefulness of periodic accounts for the purpose of comparison of one period with another may be vitiated.

Whatever be the method adopted, the periodical revision of depreciation rates and the ascertainment of the residue of cost which has not been covered by depreciation provisions made up to any given date are greatly facilitated by, and often impracticable without, the maintenance of fixed asset registers showing the cost of each asset, the provisions for depreciation made thereon and the basis on which these have been calculated.

It is therefore recommended that—

1.—Provisions for depreciation, amortisation and depletion of fixed assets should be applied on consistent bases from one period to another. If additional provisions prove to be necessary, they should be stated separately in the profit and loss account. Where practicable, fixed assets *in existence at the balance sheet date* should normally be shown in the balance sheet at cost and the aggregate of the provisions for depreciation, amortisation and depletion should appear as deductions therefrom. The extent to which these provisions are being kept liquid will then be ascertainable from the balance sheet as a whole.

2.—Such provisions should be computed on the basis mentioned below as being appropriate to the particular class of asset concerned:

(*a*) *Goodwill and Freehold Land.*

Depreciation does not arise through use in the business, except in the case of freehold land acquired for purposes such as are referred to in (*d*) below. Amounts set aside to provide for diminution in value do not constitute a normal charge against revenue and should be shown separately in the profit and loss account.

(*b*) *Freehold Buildings, Plant and Machinery, Tools and Equipment, Ships, Transport Vehicles and similar assets which are subject to depreciation by reason of their employment in the business.*

Provision for depreciation should, in general, be computed on the straight-line method. Assets of very short effective life, such as loose tools, jigs and patterns, may, however, frequently be dealt with more satisfactorily by other methods such as re-valuation, which in no case should exceed cost.

(*c*) *Leaseholds, Patents and other assets which become exhausted by the effluxion of time.*

Provision for amortisation should be made on the straight-line basis, including, in the case of leaseholds, allowance for the estimat-

ed cost of dilapidations at the end of the lease or useful life of the asset if shorter. If a leasehold redemption policy is effected with an insurance company, the charge of the annual premiums to profit and loss account provides a satisfactory method of amortisation if supplemented in respect of dilapidations.

(*d*) *Mines, Oil Wells, Quarries and similar assets of a wasting character which are consumed in the form of basic raw material or where the output is sold as such.*

Provision for depreciation and depletion should be made according to the estimated exhaustion of the asset concerned. In the case of an undertaking formed for the purpose of exploiting this particular class of asset, if the practice is to make no provision this should be made clear in the accounts so that shareholders may realise that dividends are, in part, a return of capital.

3.—Where a method different from that recommended has hitherto been followed and it is not considered practicable or desirable to make a change in the case of assets already in use, it is suggested that the methods recommended should be followed in cases of assets subsequently acquired.

4.—Details of all fixed assets should be kept (preferably in registers specially maintained) to show the cost of each asset, the provisions made for its depreciation and the basis of the provisions made.

5.—Amounts set aside out of profits for obsolescence which cannot be foreseen, or for a possible increase in the cost of replacement are matters of financial prudence. Neither can be estimated with any degree of accuracy. They are in the nature of reserves and should be treated as such in the accounts.

The question as to whether the charge for depreciation should be based on historical cost or estimated cost of replacement has already been discussed in § 5 of this Chapter.

The depreciation of patents and copyrights calls for some additional comment.

Patents

Patents suffer depreciation from effluxion of time, since a patent is only granted for a period of 16 years, though it may be subject to extension in certain cases. It is desirable, therefore, that the value of the patent should be written off over a period not longer than its official life, although in many cases a residual value remains in the shape of goodwill, built up during the continuance of the patent. Sometimes the master patent is so protected by subsidiary patents that the asset remains of considerable value.

Other causes of depreciation affecting patents are obsolescence,

the impracticability of working the patent at a profit, or failure to induce the public to buy the patented article. It by no means follows, therefore, that a patent remains of value during the whole of its life, and consequently revaluation in such cases should be resorted to. In no case should the value be written up, even though it prove to be much in excess of the cost price.

Fees incurred in taking out the patent are of a capital nature, but renewal fees for maintaining the patent must be charged to revenue, and not debited to the Patent Account.

It is preferable to adopt the *Fixed Instalment* system when it is desired to write off the whole cost of the patent over a term of years.

Copyrights

Similar considerations apply to copyrights as to patents, except that the term of copyright is considerably longer, being, with certain exceptions, the life of the author and a period of fifty years after his death. As the vast majority of copyrights do not retain any value during the greater part of their legal life, depreciation cannot be based on that period, and provision by way of *revaluation* of each copyright is the only really satisfactory method. Further remarks on this subject will be found in Chapter V, § 7(9).

§ 7. Repairs and Renewals

In discussing the question of depreciation, it has been stated that repairs and small renewals should in all cases be charged against revenue, and the auditor should ascertain whether this has been done. The distinction between small renewals, which should be charged to revenue, and replacements which can be treated as additions to capital, provided the rate of depreciation has been sufficient to eliminate the old asset, is sometimes difficult to define. It is essential for the auditor to examine carefully all amounts debited to the asset account, and, by selecting certain items for enquiry, to satisfy himself that the treatment is a proper one.

Where the expenditure on repairs is of a variable nature and considerable in amount, the estimated average annual charge under this heading may be debited to revenue, and credited to a Provision for Maintenance Account, the actual repairs in each

year being debited to this account, the balance of which should be carried forward, and stated separately in the Balance Sheet.

If such a balance becomes a debit balance, there is no reason why it should not be carried forward, so long as it is likely to be recouped by subsequent instalments; but the auditor should satisfy himself on this point, since the fact of a debit balance being created may be due to the inadequacy of the annual charge, which in such cases should be increased. In any event, the amount of the annual charge will require to be carefully watched, and adjusted from time to time.

§ 8. Reserves and Provisions

The terms "reserve," "provision" and "liability" are defined under clause 7, Part III of Schedule VI to the Companies Act, 1956, as under:

(1) For the purposes of Parts I and II of this Schedule, unless the context otherwise requires,—

(*a*) the expression "provision" shall, subject to sub-clause (2) of this clause, mean any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, or retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy;

(*b*) the expression "reserve" shall not, subject as aforesaid, include any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any known liability;

(*c*) the expression "capital reserve" shall not include any amount regarded as free for distribution through the profit and loss account; and the expression "revenue reserve" shall mean any reserve other than a capital reserve;

and in this sub-clause the expression "liability" shall include all liabilities in respect of expenditure contracted for and all disputed or contingent liabilities.

(2) Where—

(*a*) any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, not being an amount written off in relation to fixed assets before the commencement of this Act; or

(*b*) any amount retained by way of providing for any known liability;

is in excess of the amount which in the opinion of the directors is reasonably necessary for the purpose, the excess shall be treated for the purposes of this Schedule as a reserve and not as a provision.

Although these requirements of the Companies Act are applicable only to limited companies, it is most desirable, to avoid confusion, that the same meaning should be given to these terms in the accounts of all undertakings.

It will thus be seen that the term "reserve" should be used to describe amounts set aside out of profits and other surpluses which are not designed to meet any liability or contingency or diminution in value of assets known to exist at the date of the Balance Sheet and which thus remain part of the capital employed in the business. Revenue reserves are available for distribution as dividend, but capital reserves are not. The term "provision" should be used to describe amounts set aside out of profits to meet specific liabilities the amounts whereof cannot be estimated closely, and any diminution in the values of assets existing at the date of the Balance Sheet. The creation of a provision thus reduces the net assets employed in the business.

(A) RESERVES

It is not the duty of the auditor to concern himself with the adequacy or otherwise of amounts of profits set aside to reserve, since this is a matter of financial policy. Frequently, however, he may be called upon to advise as to the amount that should be carried to reserve, and as to whether it is preferable to retain the corresponding assets in the business, or to invest the amount outside the business. Where additional working capital may be usefully and profitably employed in the business, it is sound financial policy to leave such profits in the business, since the amount so utilised will probably earn a far higher return than if it were invest-

ed in marketable securities. Where, however, it is desired to reserve more than can be profitably employed in the business, a specific investment in securities should be made, to the extent of the excess amount so set aside. In this manner realisable assets can be utilised at any moment, should there be a sudden call upon the business. A reserve so invested is therefore a source of considerable strength. The fact, however, that the reserve is not invested in this manner, but is retained in the business, is not by any means a sign of weakness, since it may imply that the business is progressing, and consequently requires further working capital. At the same time the existence of such a reserve depends entirely upon the valuations placed on the assets, and if these are excessive, owing to the omission of proper provision for depreciation, or other causes, the reserve may be considerably smaller in fact than the figure at which it appears in the Balance Sheet.

Where a reserve is invested outside the business, it is called a *Reserve Fund*. It is often found in practice that this term is applied to reserves not represented by specific investments outside the business. In order to avoid misconception, it is preferable to follow the instruction given in Part I of Schedule VI to the Companies Act, 1956, as follows:

> "The word 'fund' in relation to any 'Reserve' should be used only where such reserve is specifically represented by earmarked investments."

(B) PROVISIONS

A provision is made where a loss is anticipated, but the amount thereof being unascertained, it cannot be finally dealt with. As, however, the loss will have been incurred before the date of the Balance Sheet, the Profit and Loss Account should be debited accordingly, a Provision Account being credited.

Such provisions may be made to provide for losses likely to be sustained on the realisation of certain assets, or for accruing liabilities, the precise amount of which is not known, and which will not result in the acquisition of corresponding assets.

Instances of the former class are provisions for bad debts, discounts, etc., and it is the auditor's duty to satisfy himself that all estimated losses have either been written off or provided for in this

manner.

The following are instances of unascertained liabilities in respect of which provisions will be made: loss resulting from a fire not fully covered by insurance; loss on bills discounted likely to be dishonoured; costs or damages under an action pending; claims not admitted. The auditor should ascertain that due provision has been made for all contingencies of this nature of which he is aware.

(1) *Provision for Bad Debts*

The question of bad or doubtful debts from the auditor's point of view has been fully dealt with in Chapter III, 9 (D). Having ascertained in the manner there described what provision he considers should be made under this heading, the auditor should check the Provision for Bad Debts Account in the impersonal ledger, and see that the necessary entries have been made.

It has been pointed out that it is not the duty of the auditor, as auditor, to make the provisions he considers to be necessary neither has he power to do so unless so intructed by his client, in which case he acts in the capacity of accountant. Where, however, the provisions made are, in his opinion, materially inadequate and he cannot persuade his client to increase them, he should make express reference thereto in his report.

(2) *Provisions for Discounts*

The necessity of providing for cash discount on outstanding debtors, and the anticipation of cash discount in respect of outstanding creditors, is a matter of opinion; but the auditor should see that whatever principle is adopted is applied consistently. The argument in favour of such a provision is that it is desirable that the book debts should appear in the Balance Sheet at the amount which it is expected they will ultimately realise, and that as the proportion upon which cash discount will probably be allowed can be ascertained from previous experience, this should be taken into account.

The argument against the necessity for such a provision is that as cash discount is an allowance made in consideration of the debtor paying his account within a given term of credit, the liability to allow such discount is conditional, and does not accrue

until the debtor pays. Moreover, as the discount is granted for the purpose of inducing the debtors to pay their accounts as soon as possible, it may be regarded as an expense attendant thereon. The more rapidly the debts can be realised, the less will be the working capital required, and the more frequently can that capital be turned over in the course of the trading period. From this point of view, therefore, it may very well be argued that the expense of discount should be charged against the period which receives the use of the money.

It might be added that for taxation purposes discounts will only be allowed as charges against profits of the period during which they are granted. As, therefore, provisions for prospective discounts are not allowable deductions for taxation this fact may have considerable influence on the decision whether or not to make them.

The auditor, therefore, can point out the arguments in favour of making such a provision, but it cannot be regarded as essential, and the omission to do so cannot be said to affect materially the accuracy of the Balance Sheet.

The amount of the provision necessary will be calculated either on each individual debt, or, more usually, by way of a percentage on the outstanding *good* debtors, the rate of which will be based on the discount allowed in relation to the turnover of previous years.

The anticipation of discount in respect of outstanding creditors should not be permitted, unless provision is made against discount on outstanding debtors. Similar principles will apply as to its calculation.

(3) *Provision for Fall in Value of Investments*

Where the market value at the date of the Balance Sheet of investments held as current assets is less than the book value, it is essential to provide for the loss that has occurred. Where, however, the investments are held as fixed assets provision for such a loss is not essential unless it appears to be permanent. The most convenient method of providing for the loss is to create a Provision for Depreciation of Investments Account, by debiting Profit and Loss Account with the difference between the total market value of the investments and their book value.

If this method is adopted, it will be unnecessary to amend the book value of each investment at the date of each Balance Sheet, the Provision Account being adjusted from time to time according to circumstances. In the event of any loss arising on realisation, this will be debited to the Provision Account instead of to Profit and Loss Account. In the Balance Sheet the Provision Account should be deducted from the book value of the investments.

Where no provision is made and the fall in value is considerable, the auditor should refer to the matter in this report.

CHAPTER V

THE VERIFICATION OF ASSETS

§ 1. General Considerations

One of the most important of the auditor's duties is the verification of the assets appearing in the Balance Sheet. If all transactions have been correctly recorded in the books, evidence will appear therein of all the assets that have been acquired in the course of business; but it is not sufficient for the auditor merely to verify the correctness of the Balance Sheet as shown by the books—he must go further, and verify, by actual inspection or otherwise, the *existence* of the assets. The verification of assets implies an inquiry into the *value, ownership and title; existence and possession; the presence of any charge on the assets.* The fact that there is an entry in the books recording the asset does not prove that the asset itself exists at the date of the Balance Sheet, even though the auditor may have vouched the accuracy of the entry. The entry only goes to show that the asset ought to exist, and it is the duty of the auditor to satisfy himself that it actually does so; and if his inspection or examination of evidence takes place after the date of the Balance Sheet, he must satisfy himself that the asset existed at the date of the Balance Sheet.

In the case, however, of those assets which continually change in the ordinary course of business, such as cash, bills receivable, and, in some cases, investments, an inspection should be made either at the close of business on the day of the Balance Sheet or as soon thereafter as possible. If transactions have occurred subsequent to the date of the Balance Sheet, and prior to the date of examination, these must be vouched, in order to prove the existence of the asset at the date of the Balance Sheet.

When verifying cash balances or other assets of an easily negotiable character, the auditor must take every precaution to guard against the possible substitution of assets; *e.g.*, where there are several cash balances, he must call for the production of all of them at the same time, since, if he examines them on different

days, a portion of one balance may be used to make good a deficiency in another. In a similar manner, where there is a large number of investments, care must be taken to see that all are produced at the same time. Unless proper precautions are taken, there is always the risk that assets that have already been verified by the auditor could be used to free others that have been pledged. The auditor must take all possible steps to insure that all the assets he examines are free from any charge upon them which is not properly recorded in the books of the business.

The verification of assets also serves to guard against the improper inflation of values, or the creation in the books of the record of an asset which does not exist or which in fact never has existed. The object of this form of manipulation is in most cases to inflate the profits, and correspondingly to increase the assets, thus making the position of the business, as shown by the Balance Sheet, appear stronger than it actually is. A common instance of this is the inflation of the value of stock-in-trade, either by over-valuation or by the inclusion of fictitious items.

The verification of assets, therefore, should include not only the verification of their existence, but also of the values at which they appear in the books, as far as it is possible for the auditor to satisfy himself of this.

Misapropriation of assets, inflation of profits, and falsification of the Balance Sheet, may not be detected by the auditor if he is negligent in the performance of his duties in this connection, and he may find himself liable for heavy damages in consequence.

Documents of title deposited with bankers and others for safe custody, or for the purpose of reference or sale, should actually be inspected by the auditor where possible. In any case, he should obtain a certificate from the holder stating that the assets are held free from charge; and where he relies solely upon such a certificate, he may feel it necessary to state in his report that he has done so.

The verification of the different classes of assets common to most Balance Sheets will now be considered. Assets of a special nature affecting particular businesses will be dealt with in Chapter XIV, which is devoted to the audits of different undertakings.

§ 2. Land and Buildings

(A) Freehold Property

The title deeds should be examined by the auditor, but he cannot, however, make himself responsible for the validity of the title. It is the duty of the purchaser's solicitor to verify the validity of the title acquired by his client, and it is sufficient if the auditor ascertains that the title deeds appear to be genuine, and in order, that they refer to the property, the existence of which he desires to verify, and that the sequence of the various deeds composing the title appears to be complete. He should examine the last conveyance, and see that it duly vests the property in his clients or their trustees.

If the property has been mortgaged, the title deeds will be in the possession of the mortgagee, from whom a certificate should be obtained to that effect.

The owner of freehold property may create a leasehold interest therein, whereby he reserves to himself the right to receive from the lessee an annual ground rent during the period of the lease and the reversion of the property to himself at the end thereof. The asset representing the interest of the freeholder in such property is called a freehold ground rent. The title deeds relating to the property must be examined by auditor, together with the counterpart of the lease which has been granted. The auditor should also see that all ground rents receivable during the period have been properly accounted for. In view of the right to the ultimate reversion to the property, freehold ground rents increase in value annually and no question of providing for their depreciation, therefore, arises.

Subject to any provision for depreciation that may be necessary in respect of buildings, freehold property should appear in the Balance Sheet at cost. It is not usual to write up this asset, even though its value may have increased, but where this course is followed, the method adopted must be clearly shown in the accounts. On the other hand, it is not usual to take account of any fall in the market value until realisation, when the loss can be accurately ascertained.

(B) LEASEHOLD PROPERTY

The lease and, where the client is not the original lessee, the assignment thereof, should be inspected, and the auditor should ascertain that all conditions, the non-fulfilment of which might involve forfeiture of the lease, such as prompt payment of ground rent, maintenance of fire insurance, etc., have been duly complied with.

Where leasehold property has been sub-let, the counterpart of the tenant's agreement should also be examined.

It should be seen that proper provision has been made for depreciation of leases and for any possible claims for dilapidations arising thereunder.

§ 3. Investments

Where investments are numerous, the auditor should have produced to him a schedule showing the nominal amount and full title of each investment, the book value, the paid-up value, and the market value thereof, as at the date of the Balance Sheet.

The whole of the investments should be produced at the same time, and where they are registered in the names of individuals as nominees, a deed of trust should be produced. Where no such deed is in existence, the auditor should obtain a letter from the parties, stating that they hold the investments on behalf of the company free from any charge, and he should advise that a deed of trust be executed.

In case of investments made by a company it should be noted that Section 49, Companies Act, 1956, requires that investments of a company should be held in its own name except in certain specified cases. Where the company is permitted to hold the investments in some other name, the register required to be maintained by the company in respect of such investments should be inspected.

In all cases the auditor should see that the particulars of the investments correspond with those entered on the Schedule, especially where different classes of stock or shares are held in the same company.

Where the actual securities are not examined, but the auditor obtains a certificate from bankers or other parties, the certificate

should state the names in which the securities are registered and that they are held free of any charge or encumbrance.

In recent years, many companies have raised additional capital by offering new shares to their shareholders *pro rata* to their present holdings, on terms which compare favourably with the current market value of the company's existing shares. A provisional renounceable allotment letter (often called a "rights" letter) is issued to each shareholder for the number of new shares he is entitled to take up. A shareholder who does not wish to acquire his new shares may renounce the allotment letter in favour of a third party and, in view of the favourable price at which the new shares can be acquired, the "rights" are normally quoted on the market at a premium. When a company makes a free bonus issue of shares to its existing shareholders, the normal practice is for renounceable allotment letters to be sent to the shareholders for the shares so allotted. If the shareholder wishes to keep the new shares allotted to him, he will, in due course, receive the appropriate definitive certificate (*i.e.*, the stock or share certificate defining the holding) but, within a specified period from the date of the allotment, he has the right to sell the new shares in the market, his title thereto being transferred by delivery of the allotment letter duly renounced.

It will be appreciated that the fact that bonus shares, or "rights" to take up new shares, *should* have been received will not be apparent from the relevant investment accounts, and that, therefore, these are matters into which the auditor must make the closest enquiries. Not only must the auditor make sure that the correct holding of each investment is recorded but he must bear in mind the comparative ease with which, in certain cases, allotment letters could be renounced and the proceeds of sale misappropriated. Where necessary, the auditor should ask his own stockbroker to furnish him with details of bonus and "rights" issues made by particular companies or should himself refer to the appropriate cards issued by an agency which provides a daily statistical service.

As the number of bonus shares issued to each shareholder is calculated *pro rata* to his existing holding, a fraction of a share will frequently arise. Where a shareholder is entitled to a fraction of a bonus or right share, the company will issue vouchers or coupons denoting fractional rights. In case of quoted shares,

such fractional rights can be purchased and sold on the basis of the market quotations. In case of other companies, the purchase and sale of fractional rights are negotiated privately. It is usual for the shares representing these fractions to be sold by the company and for the proceeds to be divided between the persons entitled thereto. The auditor should, therefore, ensure that the cheques for any fractions due to his client have been properly accounted for.

(A) REGISTERED STOCKS AND SHARES

The term "registered" implies that the name of the holder has been entered in the register of the company, and that a certificate has been issued in his name. The certificate will be examined, and the auditor should see that it appears to be properly executed and sealed.

Where registered stocks or shares have been sold prior to the date of the Balance Sheet, but delivery has not been effected by that date, the certificate will not have been handed over, and should be produced, together with the broker's sold note; or if the certificate has been sent to the broker his receipt should be seen. If delivery has been effected, it should be seen that the proceeds of sale have been duly received.

Where part of a holding has been sold, and the certificate for the total holding has been delivered, but no new certificate has yet been issued, the auditor should call for a certificate from the stockbrokers who effected the sale stating that they are due to deliver a certificate for the balance unsold.

Where shares have been purchased, but the new certificate has not been issued at the date of the audit, the auditor should ask for a certificate from the stockbrokers who effected the purchase stating that they are due to deliver the relevant share certificate.

(B) CO-OPERATIVE BUILDING SOCIETY DEPOSITS AND SHARES

The auditor should obtain a certificate from the co-operative society confirming the balance standing to the credit of client's deposit account and the shares held by the client at the date of the Balance Sheet.

(c) Treasury Bills

These securities, which are payable to bearer, are normally held by the client's bankers for safe custody. A certificate should, therefore, be obtained from the bank setting forth the date and face value of each bill held by them and certifying that they have no charge thereon.

If Treasury bills are actually in the possession of the client, they should be examined by the auditor who should see that they are not out of date. If, before the auditor attends to verify securities, the Treasury bills have matured, he will vouch the proceeds from the bank statement and collection advice received from the client's bankers.

Treasury bills should be grouped in the Balance Sheet with the current assets and be stated at cost or at their face value discounted at the market rate.

(d) The Verification of the Values of Investments

Investments should appear in the Balance Sheet at cost or under, and brokers' bought notes will be sufficient evidence of the price paid. The necessity or advisability of providing for depreciation can only be considered in relation to the present value of the investments, and the auditor should, therefore, ascertain this as far as he is able to do so.

In the case of stocks and shares quoted on a recognised stock exchange, the Official List published at the date of the Balance Sheet should be consulted and the middle price taken. Stocks and shares not officially quoted may nevertheless be quoted by financial papers, and if so, the mean of the various markings should be taken.

Where no market quotation exists, considerable difficulty is sometimes experienced in arriving at a fair estimate of the value. Enquiries can be made of the secretary of the company concerned, as to the recent prices at which shares have been transferred; but this is not necessarily a true criterion of the value, inasmuch as, where no free market exists, the purchase consideration does not always represent the actual value. In any case, such information is not sufficient, and the auditor should ascertain what dividends have been paid recently on the shares, and inspect a copy of the last audited Balance Sheet of the company concerned.

Investments should not be written up except in special circumstances, as in the case of changes in a partnership; but on a revaluation of all the investments a rise in the value of some may be set off against a fall in the value of others.

The verification of investments, in the case of limited companies raises special considerations which are dealt with in Chapter X.

§ 4. Stock-in-Trade

As the correctness of the profits of a trading concern depends, to a large extent, on the accuracy of the valuation of the stock-in-trade at the date of the Balance Sheet, the verification of this asset forms a very important part of the auditor's duties. This verification, however, is attended by many more difficulties than is the case with other assets, inasmuch as no entries will usually appear in the financial books, showing what stock-in-trade should be on hand. Where accurate stock records are kept, evidence is available which will materially assist the auditor to satisfy himself as to the correctness of the stock, but in the great majority of businesses the maintenance of such detailed accounts is not practicable. The auditor cannot normally be expected to verify the existence of each item of stock by actual inspection. He is not a valuer, and the technical knowledge of the trade concerned, which he may or may not possess, will not as a rule be sufficient to enable to form an opinion as to the correct valuation of the stock. He is usually unable, therefore, to verify the existence of this asset, by actual inspection or documentary evidence and he cannot assure himself of the accuracy of its value by the methods which are available in the case of other assets, such as investments. Accordingly the verification of stock is usually restricted to making such tests of the accuracy of the stock sheets as are possible in the circumstances.

Although the above represents the view generally held in this country as to the duty and responsibility of the auditor with regard to stock, it is prudent to point out that the accountancy profession in the United States of America has, as a result of the disclosures in the *McKesson & Robins* case, formally acknowledged the physical verification of inventories to be part of normal auditing practice, and some controversy has arisen as to whether

a similar procedure should not be adopted in this country. The facts of that case were that the president of McKesson & Robins, Incorporated (Maryland), in collusion with certain other of the company's high officials, fabricated and presented to the auditors a completely fictitious set of records of purchases, sales and stock inventories, which resulted in the assets being overstated in the Balance Sheet by approximately 21,000,000 dollars.

In a summary of their findings and conclusions on the case, published in 1941, the Securities and Exchange Commission stated that they found that a difference of opinion existed among accountants as to the auditor's duties and responsibilities in connection with the physical verification of quantities, quality and condition of stocks. The auditors of the company, in common with a substantial section of the profession, took the position that the verification of inventories should be confined to the records. On the other hand, a body of equally authoritative opinion supported the view, which the Commission endorsed, that auditors should gain physical contact with the inventory, either by test counts, or by observation of the taking of the inventory, or by a combination of these methods.

(A) Method of Stock-taking

Whenever practicable, stock should be taken immediately after the close of business on the last day of the period, one person calling out the quantities and description of the goods, and another entering them on the stock sheets. The price at which each item of stock is to be valued will be entered later by a responsible official and the total values will be calculated and extended. The calculations and costs should be checked by someone who has taken no other part in the stock-taking and each person should initial for the work he has performed. The completed stock sheets should be certified by a manager, partner, or director.

Care should be taken to see that all goods not on the premises, but which form part of the stock of the business, and in respect of which invoices have been passed through the books are included. Instances of this class are stock in transit, at the docks, in the hands of agents or customers, or at branches.

On the other hand, no item should be taken into stock in respect of which invoices have not yet been passed through the

books, unless the property therein resides in the purchaser at the date of the Balance Sheet, when it should be seen that the corresponding liability is also included. It should be ascertained that no goods are taken into stock which have been sold and already treated as sales, although not yet delivered to the customers, and in the same way no goods held on behalf of third parties, by way of consignment or agency, should be included.

In some businesses it may be necessary to spread the work of stock-taking over several days. In such cases, special precautions must be taken to ensure that goods received after the date of the Balance Sheet are not taken into stock and that due allowance is made for goods which were, in fact, in stock at the close of the financial period but have been sold and delivered before that particular stock is taken.

Unless great care is exercised, errors are almost certain to arise in connection with stock-taking. In many cases the people employed to take stock are not competent to distinguish between one class of stock and another, or to realise how seriously errors of this nature may affect the accounts. Consequently, active and efficient supervision on the part of some responsible official is essential.

(B) Basis of Valuation

Stock should be valued at cost, net realisable value or replacement price, whichever is the lowest at the date of the Balance Sheet.

The recommendations on the treatment of stock-in-trade and work in progress in financial accounts which were made by the Council of the Institute of Chartered Accountants in England and Wales in November 1960 are given hereunder:

> In the financial accounts of industrial and commercial undertakings few matters require more careful consideration than the amount to be attributed to stock-in-trade and work in progress. Circumstances vary so widely that no one basis of arriving at the amount is suitable for all types of business nor even for all undertakings within a particular trade or industry. Unless the basis adopted is appropriate to the circumstances of the particular undertaking and used consistently from period to period, the accounts will not give a true and fair view either of the state of affairs of the undertaking as on the balance sheet date or of the trend of its trading results from period to period. The need to give a true and fair

view is the overriding consideration applicable in all circumstances.

In order to arrive at the amount to be carried forward, as on the balance sheet date, for stock-in-trade and work in progress it is necessary to ascertain (from stocktaking at the end of the period or from stock records maintained and verified during the period) the quantities on hand and to make a proper calculation of the amount. It cannot be emphasised too strongly that all stocks belonging to the business should be taken into account, whatever their location or nature. This recommendation does not deal with the methods of ascertaining the quantities on hand but is confined to an examination of the factors to be considered when computing the amount. The word "stock" is used hereafter to embrace stock-in-trade and work in progress.

NORMAL BASIS

The basis normally used for the determination the amount to be carried forward for stock is its cost less any part thereof which properly needs to be written off at the balance sheet date. It is in computing cost and the amount, if any, to be written off that practical difficulties arise.

COST

Elements of cost

The elements making up the cost of stock are:

(*a*) direct expenditure on the purchase of goods bought for resale, and of materials and components used in the manufacture of finished goods;

(*b*) other direct expenditure which can be identified specifically as having been incurred in acquiring the stock or bringing it to its existing condition and location; examples are direct labour, transport, processing and packaging;

(*c*) Such part, if any, of the overhead expenditure as is properly carried forward in the circumstances of the business instead of being charged against the revenue of the period in which it was incurred.

TREATMENT OF OVERHEAD EXPENDITURE

Before deciding upon the method by which to compute "cost" it is necessary to consider to what extent, if at all, the inclusion of overhead expenditure is appropriate to the particular business.

Overhead expenditure may be divided into (*a*) production expenses such as factory rent, rates, depreciation, insurance and supervision, and other indirect expenses of acquiring and producing stock; (*b*) administration expenses not attributable directly to the acquisition or production of stock or the bringing of it to a saleable condition and location; (*c*) selling expenses; (*d*) finance charges. Another classification (which can be applied also to each of the foregoing divisions) is to distinguish between

"fixed overheads," that is to say standing charges such as rent and rates which accrue and expire wholly or largely on a time basis, and "variable overheads," which vary in a greater or lesser degree with the level of activity of the undertaking or of the department concerned but are not so closely associated with production or the volume of production as to be classed as direct expenditure.

Opinions differ on the extent to which overhead expenditure should be included in computing the cost of stock, though it is generally agreed that it cannot properly include selling and finance and other expenses which do not relate to the bringing of stock to its existing condition and location. The following are some practices which reflect the differing views on this matter.

(*a*) in some businesses no overhead expenditure is included as an element in determining the cost of stock which is to be carried forward;
(*b*) in others only the "marginal" cost of unsold stock is included, that is to say that part of the cost of production of the period which has been incurred only because the stock remaining on hand was acquired or produced; all other expenses, including depreciation, are dealt with as revenue charges of the period for which they are incurred, the ground being that they arise irrespective of the quantity of stock which remains on hand at the end of the period and therefore are not an element in its cost;
(c) in other businesses an appropriate proportion of the overhead expenditure relevant to the period of production is included on the ground that for the purpose of financial accounting any expense, whatever its characteristics, which is related even though indirectly to the acquisition or production of goods ought to be included in the cost of those goods and ought not to be charged against revenue until they are sold; an "appropriate proportion" is determined by reference to a normal level of activity.

These differing views about the inclusion of overhead expenditure may be very important in their effect upon the amounts carried forward for stock and upon the profits disclosed in the accounts. No one method of dealing with overhead expenditure is suitable for all businesses. The method selected by the management needs to be clearly defined and must have regard to the nature and circumstances of the business so as to ensure that the trend of the trading results will be shown fairly. Once the method has been selected it needs to be used consistently from period to period regardless of the amount of profits available or losses sustained. A change of method is appropriate only if there is a change in the relevant circumstances of the business. If material, the effect of a change of method would need to be disclosed in the accounts.

In selecting a method of dealing with overhead expenditure the following are among the considerations which arise:

(*a*) *The nature of the business*

In deciding whether to include a proportion of the overheads as expenditure on stock and also in deciding which elements of expenses may properly be included for that purpose, it is necessary to have regard to the nature and the stage of development of the business, particularly factors such as the length of the production period, the probability of fluctuations in the level of production or the volume of sales, the risk of selling campaigns by competitors at reduced prices and the extent to which production is undertaken only to a customer's order or "for stock" in expectation of sales. At one extreme a business may operate at widely differing levels of production and produce goods in quantity in a highly competitive and sensitive market; at the other extreme, a business may be engaged on a long-term single project contract such as building a ship, a bridge, a road or a heavy engineering installation.

(*b*) *The levels of production and sales*

Where the levels of production and sales are relatively stable and production and sales are kept in balance the inclusion of overhead expenditure in the amount attributed to stock may have little impact upon the incidence of profits as between the accounts of one period and those of another. Where, however, the levels are subject to material fluctuation and are not kept in balance it may be decided to exclude these expenses from stock on the ground that as they would be incurred whatever the levels of production or sales their inclusion in stock has the effect of relieving the profit and loss account in the period when they are incurred of expenses which it should fairly bear and of charging these expenses in a later period to which they do not properly relate.

(*c*) *Interruption or other exceptional curtailment of production*

If overhead expenditure is included in the amount attributed to stock an adjustment will be necessary in the event of disruption in production by events such as a strike, a fire, an abnormal falling off in orders, or temporary difficulties in obtaining materials, with the result that the volume of production is abnormally or unexpectedly low. In such circumstances the amount included in respect of overhead expenditure ought not to exceed an appropriate proportion on the basis of normal activity (*see* paragraph (c)), the excess being treated as a charge against revenue in the period in which the expenditure was incurred. If the overhead expenditure is not related in this way to the normal, instead of the actual, level of production the effect may be to carry forward an excessive part of the expenditure of the period in which the disruption occurred. The profit and loss account of that period would thereby be relieved of charges which it ought to include and it would fail to reflect the adverse effects of the disruption during that period.

(*d*) *The risks of realisation at a loss*

In businesses which are highly competitive or have a sensitive market for their products, overhead expenditure may properly be omitted in order to avoid carrying forward expenditure which may prove irrecoverable. Examples are businesses dealing in "fashion" goods or those of a speciality character where the public taste may change quickly with the result the stocks can be realised only at a loss; businesses whose competitors may launch selling campaigns at short notice to get rid of stocks at reduced prices, sometimes at no more than the cost of the material and direct manufacturing expenditure; and businesses where new methods of production or improved designs may render existing stocks obsolete.

(*e*) *Maturing stocks*

In businesses which mature large stocks over long periods (for example, whisky, wine, timber) it is usual to exclude fixed overheads in order to avoid carrying forward large and increasing amounts of time-expired expenditure, the recovery of which in the ultimate selling price is uncertain.

(*f*) *Long-term contracts*

In businesses which undertake contracts extending over a period of years the normal tendency is to include overhead expenditure in work in progress except where it is considered to be irrecoverable. If overheads are not included in work in progress on such contracts the accounts for the early years may indicate losses, followed by unduly large profits in the years when the contracts are completed. This would be a wholly unrealistic presentation in relation to a contract showing a normal profit. The distinction between businesses of this type and those referred to in (*e*) above is that in a business with firm contracts the prices are normally known or can be calculated whereas in a business with maturing stocks the ultimate price at which unsold stocks will be realised in the ordinary course of business is unknown and uncertain.

(*g*) *The extent of the variation in fixed or standing charges*

The less the fixed or standing charges vary in amount with variations in the volume of output, and the more they accrue on a purely time basis, the greater is the justification for their exclusion.

After weighing all relevant considerations it is necessary to decide whether and if so to what extent overhead expenditure should be included.

METHODS OF COMPUTATION OF COST

Apart from the variations which occur in calculating the amount to be attributed to each of the elements of cost there are various methods

of computing cost. In a small business one method only will normally be used but in a large composite business carrying on a variety of activities different methods may be used for different activities; once selected, however, the methods should be applied consistently to those activities from period to period. The following are the principal methods:

(*a*) *"Unit" cost*

The total cost of stock is computed by aggregating the individual costs of each article, batch, parcel or other unit. The method is not always capable of application, either because the individual units lose their identity (notably where stocks are bulked or pass through a number of processes) or because it would involve undue expense or complexity to keep individual records of cost particularly where these necessitate allocations of expense.

(*b*) *"First in, first out"*

Cost is computed on the assumption that goods sold or consumed are those which have been longest on hand and that those remaining in stock represent the latest purchases or production.

(*c*) *"Average" cost*

Cost is computed by averaging the amount at which stock is brought forward at the beginning of a period with the cost of stock acquired during the period; consumption in the period is then deducted at the average cost thus ascertained. The periodical rests for calculating the average are as frequent as the circumstances and nature of the business require and permit. In times of rising price levels this method tends to give a lower amount than the cost of unsold stock ascertained on a "first in, first out" basis and in times of falling prices a higher amount.

(*d*) *"Standard" cost*

A predetermined or budgeted cost per unit is used. The method is particularly convenient where goods pass through a number of processes or are manufactured on mass production lines; but it will not result in a fair approximation to actual cost unless there is a regular review of the standards with appropriate adjustment and revision where necessary.

(*e*) *"Adjusted selling price"*

This method is used widely in retail businesses. The cost of stock is estimated by calculating it in the first instance at selling prices and then deducting an amount equal to the normal margin of gross profit on such stocks. It should be appreciated that where the selling prices have been reduced the calculation will bring out cost only if appropriate allowance for price reductions is included in fixing the margin to be deducted; if no such allowance is made it

may bring out amounts which approximate to replacement price as defined below. The calculations under the method may be made for individual items or groups of items or by departments.

REDUCTION TO NET REALISABLE VALUE

When the cost of the stock has been determined it is then necessary to establish whether any portion of the outlay on stock is irrecoverable; to that extent a provision for the loss needs to be made. This calculation may be made either (i) by considering each article separately, or (ii) by grouping articles in categories having regard to their similarity or interchangeablility, or (iii) by considering the aggregate cost of the total stock in relation to its aggregate net realisable value. The third method involves setting foreseeable losses against expected but unrealised profits and would not normally be used in businesses which carry stocks which are large in relation to turnover.

The irrecoverable portion of the cost of the stock is the excess of its cost as computed by the method of cost ascertainment which is deemed appropriate for the business, over the net realisable value of the stock. "Net realisable value" means the amount which it is estimated, as on the balance sheet date, will be realised from disposal of the stock in the ordinary course of business, either in its existing condition or as incorporated in the product normally sold, after allowing for all expenditure to be incurred on or before disposal.

"Net realisable value" is estimated by taking account of all available information, including changes in selling prices since the balance sheet date, so far as the information is of assistance in determining, as on the balance sheet date, the net realisable value of the stock in the ordinary course of business. This involves consideration of the prospects of disposal, having regard to the quantity and condition of the stock in relation to the expected demand (particular attention being given to obsolete or excessive stock) and to the expected effect, if any, on selling prices of any change which has taken place in buying prices of materials or goods.

In some circumstances the replacement price of stock (as defined below) may be considered to be the best available guide to its net realisable value.

REDUCTION TO REPLACEMENT PRICE

In many businesses it is important to have regard to the price at which stock can be replaced if such price is less than cost. The considerations which lead to the use of replacement price include the following:

(*a*) *Uncertainty as to net realisable value*

Where the volume of stock carried is large in relation to turnover or there is a long period between the purchase of raw material and its conversion into and disposal as finished goods, selling prices

current at the balance sheet date for the volume of orders then available may afford an unreliable guide to the prospective net realisable value of the stock as a whole. Replacement price may be considered to be the best available guide for this purpose.

(*b*) *Selling prices based on current replacement prices*

In some businesses where selling prices are based on or reflect current replacement prices it may be considered that the trading results of a subsequent period will be prejudiced if they are burdened with any amount for stock which exceeds its replacement price; where this view is taken it is regarded as important in reporting the results of the activities of a period, as compared with those of its successor or predecessor, that the period in which a reduction in buying prices occurs should bear the diminution in profit rather than the period of disposal whose realisations will be adversely affected by the events of the previous period.

(*c*) *Recognition of uneconomic buying or production*

Skill in buying or efficiency in production are most important matters in many businesses; the inclusion of stock in the accounts on a replacement price basis (where lower than net realisable value and cost) may be considered to reflect inefficiency in these respects on the ground that it involves the writing down of stock by an amount which represents approximately the result of misjudged buying or inefficient production.

Where replacement price basis is adopted the stock is stated at the lowest of (*a*) cost, (*b*) net realisable value, (*c*) replacement price, with the effect that the profit and loss account is charged with any reductions necessitated by an excess of (*a*) over (*b*) or (*c*) as the case may be.

"Replacement price" for this purpose means an estimate of the amount for which, in the ordinary course of business, the stock could have been acquired or produced either at the balance sheet date or during the latest period up to and including that date. In a manufacturing business this estimate would be based on the replacement price of the raw material content plus other costs of the undertaking which are relevant to the condition of the stock on the balance sheet date. In all cases the prices used should be a fair reflection of the ordinary course of business; a depression which has passed before the accounts are completed would generally be disregarded.

In the same way as it is necessary to decide whether and if so to what extent overhead expenditure should be included in calculating cost, it is necessary in each business to determine whether replacement price shall be taken into account in computing the amount carried forward for stock. The basis selected by the management should be clearly defined and applied consistently from period to period regardless of the amount of profits available or the losses sustained, so as to enable the accounts to

show a true and fair view of the trading results and the financial position. If the basis is changed, the effect on the accounts would need to be disclosed if material.

SPECIAL BASES USED IN SOME BUSINESS

STOCKS AT SELLING PRICES

In some types of businesses, such as tea and rubber-producing companies and some mining companies, it is a recognised practice to bring stocks of products into account at the prices realised subsequent to the balance sheet date, less only selling costs. By this means the whole of the profit shown in the period in which the crop is reaped or the minerals won. This basis has come to be accepted as customary in the industries concerned.

In manufacturing businesses which carry stocks of by-products the separate cost of which is not ascertainable these stocks are normally included at current selling price (or contract sale price where applicable) less any expenses to be incurred before disposal; the cost of the main products is reduced accordingly.

LONG-TERM CONTRACTS

In businesses which involve the acceptance and completion of long-term contracts it is often appropriate to spread over the period of the contracts, on a properly determined basis, the profits which are expected to be earned when the contracts are completed. This procedure takes up in each period during the performance of the contract a reasonable amount as representing the contribution of that period towards the eventual profit; it thus recognises to a prudent extent the value of the work done in each period and restricts the distortion which would result from bringing in the whole profit in the period of completion. The principles which determine whether an element or profit is to be included are:

(*a*) profit should not be included until it is reasonably clear from the state of the work that a profit will ultimately be earned; it is therefore inappropriate to include any profit element where at the balance sheet date the contract has been in progress for a comparatively short time or to include an amount in excess of the profit element properly attributable to the work actually done;
(*b*) provision should be made for foreseeable losses and allowance should be made as far as practicable for penalties, guarantees and other contingencies;
(*c*) a clear basis for including a profit element should be established and adhered to consistently.

"BASE STOCK"

In some businesses the minimum quantity of raw materials or other goods, without which they cannot operate their plant or conduct their

operations, is treated as being a fixed asset which is under constant renewal by charges to revenue; that part of their stock (the base stock) is therefore carried forward not at its cost at the date of the accounts but at the cost of the original quantity of stock with which the business commenced operation. In old established businesses the amount will be based on prices paid for stocks acquired many years previously and many times replaced.

"LAST IN, FIRST OUT"

The "last in, first out" basis, which is in use in some overseas countries assumes that the stocks sold or consumed in any period are those which were most recently acquired or made and therefore that the stocks whose cost is to be carried forward are those which were acquired, or made, earliest. The result is to charge consumption at prices approximating to current replacement prices and to carry forward stocks held at the close of the period at prices at which goods were purchased, or made, in earlier periods. When prices are falling this basis may result in showing the stock at an amount in excess of current prices in which event provision is made for the excess. During periods of rising price, except in those instances where the physical movement of goods corresponds with the assumption that "last in" is "first out," the effect is to state the stock at less than its cost. The amount carried forward for stock may represent prices at which goods were acquired or produced several years earlier.

DESCRIPTION IN THE ANNUAL ACCOUNTS

In most businesses the amounts carried forward for stock from one period to another are material in their effect upon the presentation of the trading results and financial position. The differences which exist among the methods which are recognised as proper for the computation of those amounts are also so important that, unless an indication is given of the way in which the amounts are computed, the significance of the results and of the financial position shown by the accounts may be obscured. The following illustrations of how such an indication might be given concisely where the circumstances make this appropriate:

(*a*) *Normal basis*

"at cost."

"at the lower of cost and net realisable value."

"at the lowest of cost, net realisable value and replacement price."

"at cost less provision to reduce to net realisable value," (or "to the lower of net realisable value and replacement price.")

The expression "market value" does not indicate whether it implies net realisable value or replacement price and is therefore not regarded as an appropriate description. Such terms as "at or under cost" or "as valued by the company's officials" are also not regarded as suitable.

(*b*) *Special bases*

If one of the special bases mentioned above is used an appropriate description would be required.

Whether a concise indication on the lines of the illustrations given above will be adequate for an appreciation of the significance of the accounts will depend upon the circumstances of the undertaking. The use of the word "cost" may be inadequate unless it is accompanied by an explanation of the extent to which overhead expenditure is included as cost; in that event the explanation might be as follows:

"Cost is confined to materials, direct wages and direct expenses, no addition having been made for overhead expenditure."
"Cost includes an appropriate proportion of variable overhead expenditure but excludes fixed overhead expenditure."
"Cost includes an appropriate proportion of all production and administrative overhead expenditure."

In some businesses the complex nature of the stock and the use of different bases and methods of computation for determining the amounts of the various sections of the stock, particularly in a large composite undertaking or a holding company with subsidiaries of different types, may mean that no concise indication is feasible. In such circumstances it is, however, important that those to whom the accounts are submitted should have a specific assurance that the amount included for stock has been determined for the whole of the stock at the balance sheet date on bases and by methods of computation which are considered appropriate in the circumstances of the business and have been applied consistently.

The effect of any change of basis or method of computation should be disclosed if the effect of the change is material.

RECOMMENDATIONS

Having regard to the foregoing considerations, it is recommended that the following principles be applied by every industrial and commercial enterprise.

Appropriate amounts for all stock-in-trade (including raw materials and partly finished or finished stocks) and all work in progress, wherever situated and whatever their nature, should be included in the financial accounts and should be computed in accordance with the recommendations below. There is no justification for the omission of stock nor for stating stock at an amount which is higher or lower than the amount so computed; to use a higher amount would be to overstate profits (or understate losses) of the period and reduce the profits (or increase the losses) of the next period, whilst to use a lower amount would be to create a reserve which should be so described and disclosed and should not be treated as a charge against revenue.

A profit should not be anticipated unless this is justified by the special bases used in some businesses but provision should be made to the full extent of expected losses.

The amount carried forward for stock and work in progress should be computed on a basis which, having regard to nature and circumstances of the business, will enable the accounts to show a true and fair view of the trading results and the financial position. In most businesses the basis should be the cost of the stock held, less any part thereof which properly needs to be written off at the balance sheet date.

The circumstances of each business should determine the basis which is appropriate and the method of computation which should be adopted in determining cost and the part thereof, if any, which should be written off. In most businesses the choice lies between writing off any excess of cost over either (*a*) the net realisable value of the stock, or (*b*) the lower of net realisable value and replacement price, these terms having the meanings attributed to them below. In some businesses it may be appropriate to use special bases, including some which depart from the rule that profit should not be anticipated.

The basis adopted and the methods of computation should be used consistently from period to period. A change of basis or method should not normally be made unless the circumstances have changed in such a way that its continued use would prevent the accounts from showing a true and fair view of the position and results. When a change is made the effect, if material, should be disclosed as an exceptional item in the profit and loss account or by way of note.

The following are the meanings attributed to "cost," "net realisable value" and "replacement price" in this Recommendation:

(*a*) "cost" means all expenditure incurred directly in the purchase or manufacture of the stock and the bringing of it to its existing condition and location, together with such part, if any, of the overhead expenditure as is appropriately carried forward in the circumstances of the business instead of being charged against the revenue of the period in which it was incurred;

(*b*) "net realisable value" means the amount which it is estimated, as on the balance sheet date, will be realised from disposal of the stock in the ordinary course of business, either in its existing condition or as incorporated in the product normally sold, after allowing for all expenditure to be incurred on or before disposal;

(*c*) "replacement price" means an estimate of the amount for which in the ordinary course of business the stock could have been acquired or produced either at the balance sheet date or in the latest period up to and including that date. In a manufacturing business this estimate would be based on the replacement price of the raw material content plus other costs of the undertaking which are relevant to the condition of the stock on the balance sheet date.

The comparison between cost and net realisable value or replacement price may be made by considering each article separately, or by grouping articles in categories having regard to their similarity or interchangeability, or by considering the aggregate cost of the total stock in relation to its aggregate net realisable value or, as the case may be, aggregate replacement price. The aggregate method involves setting foreseeable losses against unrealised profits on stock and may not be suitable for businesses which carry stocks which are large in relation to turnover.

Where the amount carried forward for stock is material in relation to either the trading results or the financial position, the accounts should indicate concisely the manner in which the amount has been computed. If this is not practicable the accounts should contain a note to the effect that a concise statement of the bases and methods used is not practicable but that the amount has been determined for the whole of the stock at the balance sheet date on bases and by methods of computation which are considered appropriate in the circumstances of the business and have been used consistently. The use of the term "market value" should be discontinued.

Goods purchased forward do not form part of the stock-in-trade or work in progress on the balance sheet date but where they are not covered by forward sales provision should be made in the accounts for the excess, if any, of the purchase price over the net realisable value (or over replacement price, where lower than net realisable value, if stock is stated at the lowest of cost, net realisable value, and replacement price). Similarly, where goods have been sold forward and are not covered by stocks and forward purchases, provision should be made in the accounts for the excess, if any, of the expected cost over their net realisable value. Such provisions should not be deducted from the amount at which stock is stated.

The operation of the *base stock* method is as follows: Where base or standard quantities of materials, etc., are essential to the proper functioning of a business, the initial stock at the commencement or first adoption of the scheme is valued at actual cost at that date and all replacement of that stock up to but not exceeding the initial quantity are valued at the same prices. (In effect, the original stock is thus regarded as a fixed asset). All additions to the respective quantities of stock, after deducting the consumption or disposals during the accounting period are valued at the average cost of those additions. The cost of the additions thus ascertained is added to and averaged with the "base" stock to form a moving average price of the entire stock of each of the respective kinds of goods. If, at any accounting date, cost or market value of stock is lower than the value determined by the

base stock method, the lower value would be substituted and that lower value would then be adopted as the opening figure for the next accounting period. The method has the advantage of minimising the fluctuations in stock values caused by changing price levels.

This method has not been accepted by the Income Tax authorities for Income Tax purposes. There are, in practice, many variations of the base stock method, but the above explains the more general application of the system.

Other classes of stocks may be on hand at the date of the Balance Sheet in addition to normal stock-in-trade, *e.g.*, stores for the upkeep and maintenance of plant and machinery, fuel, etc. Where these are of any consequence, it is desirable that a valuation thereof should be taken, in order that the amount charged against revenue may represent the actual quantity consumed during the period under review. In order to effect this, such stock should be brought down as a debit balance on the expenditure account to which it relates, and not included in the general total of stock-in-trade taken to the credit of the Trading Account.

(c) The Auditor's Duty in Relation to Stock-in-Trade

The extent to which the auditor is responsible for the value of the stock-in-trade appearing in the Balance Sheet was considered in the case of the *Kingston Cotton Mill Co.* (No. 2, 1896, 2 Ch. 279), which will be fully discussed in Chapter XII, § 5.

When considering this case, however, it must be remembered that it was decided more than half a century ago, when the standard of skill and care required of an auditor was probably not so exacting as it is now, and it would be imprudent to rely too implicitly on this decision in the light of current conditions. The Companies Act, 1956, requires the auditor of a company to report whether the Balance Sheet shows a true and fair view of the state of the company's affairs, and, as has been shown, in order to do this he must verify the continued existence and values of the various assets disclosed therein.

The auditor cannot confine himself to seeing that the stock is duly certified; he must, in addition, impose such tests upon the stock-sheets as are possible in all the circumstances. The tests to be imposed must depend upon the nature of the business and the

records which are kept. If a proper costing system is in operation, stores and stock accounts will be maintained, and if these are tested and found to be satisfactory the auditor is entitled to rely on the quantity balances shown thereby at the date of the Balance Sheet. In some businesses it is possible to ascertain the total quantities purchased and sold during the year, so that, after adjusting for the openingstock, the approximate quantity which should be in hand at the end of the period can be determined without difficulty. In other businesses it is possible to associate each item sold with its purchase, *e.g.*, a dealer in secondhand motor cars, so that by the process of elimination the unsold items representing the closing stock can be ascertained. In the majority of businesses, however, the verification of stock is not facilitated by the nature of the business or by the records maintained, and the auditor must rely on such tests as are possible in the circumstances. The work that should be performed in most cases may be summarised as follows:

Generally

(1) Ascertain the method of stock-taking which was adopted in order to make certain that reasonable precautions were taken to guard against the most likely types of error.

(2) Check the rough original stock-sheets with the fair copies thereof, noting and enquiring into any material alterations.

(3) Examine the stock-sheets to see that they contain only goods normally dealt in by the business, and to make sure that, in particular, the following are excluded:

   (*a*) Plant, loose tools, office furniture, motor cars, and other assets already recorded separately in the books.
   (*b*) Goods held on consignment or on sale or return.
   (*c*) Stocks of stores, fuel, etc., which should be taken at cost, and brought down on the relevant expense accounts.

(4) If quantity columns are maintained in the Bought and Sold Day Books or their equivalent, ascertain from the difference between such columns, plus the quantity on hand at the commencement of the period, the quantity which should

have been held at the balancing date. Any material difference between the quantity so computed and that shown in the stock sheets must be investigated.

(5) Where quantity stock accounts or costing records are maintained, examine these to verify the quantities shown on the stock-sheets. Differences that are not automatically accounted for should be enquired into.

(6) Where stock is held by agents, or in bonded warehouses, certificates should be obtained, and compared with the stock-sheets.

(7) See that all goods taken into stock are included in purchases, by examining the Goods Received Books for the last few days of the period, testing the invoices for the new period, and agreeing suppliers' statements with their ledger accounts or the schedule of unpaid accounts.

(8) See that no goods invoiced out to customers before the balancing date have been included in stock. Test the Goods Outwards Book, or despatch advices from the warehouse, with Sales Day Books or copies of sales invoices, seeing that any items despatched after stock-taking but invoiced in the previous financial period, were excluded from stock.

(9) See that stock is valued at the lowest of cost, net realisable value or replacement price, and note that:

(*a*) Obsolete or defective stock is properly written down.
(*b*) Prices of finished goods are below the listed or advertised selling prices.
(*c*) All trade discounts have been deducted.

(10) Compare the stock sheets with those of the previous year and enquire into the major differences in prices and quantities.

(11) Where stocks are in bonded warehouses, examine the warrants and obtain certificates for all stocks in the hands of other parties. Documents of title to stock may be lodged with bankers or others as security for advances, and in that case the auditor should obtain a certificate from such parties, and verify the amount of the loan so advanced.

(12) Test the extensions and costs of the stock sheets.

(13) Compare the percentage of gross profit on turnover with that of previous periods, and ascertain the cause of any material increase or decrease.

(14) See that each sheet of the rough stock sheets is initialled by the parties concerned in its preparation, and that the whole is properly certified by some competent official.

Finished Goods

Where there are stocks of goods manufactured by the firm the auditor must ascertain:

(1) The precise basis on which the cost of such goods has been calculated and satisfy himself, from costing or other records, that the materials and labour content are reasonable and that the amount included for overhead expenses is not excessive.

(2) The prices at which the goods are being sold in the suceeding period and whether such prices warrant the values placed upon the stock. It must also be seen that no goods are valued in excess of cost and that, if the realisable value of the goods has fallen or the replacement price is lower that the lowest price is taken.

(3) Whether the quantity shown to be in stock is reasonable having regard to the firm's manufacturing capacity, the speed of the manufacturing operations and the sales of the products in question during the last few days of the financial period.

Work-in-Progress

(1) If Cost Accounts are maintained, test the allocation of materials and wages and if a proportion of overhead expenses has been included in the valuation, see that this is not excessive.

(2) Compare the total value of work in progress and the basis of valuation with that of the previous year and inquire into variations of any importance.

(3) If no Cost Accounts are kept obtain a detailed statement showing the compilation of the Work-in-Progress figure; test the prices at which materials have been included and

wages charged, and ascertain that the overheads included, if any, have been allocated on a reasonable basis and conform with previous practice.

(4) Consider the quantity of Work-in-Progress in the light of (*a*) the time involved in the manufacturing operation; and (*b*) the normal output.

(5) Confirm that proper provision has been made for all amounts due to creditors for supplies, services, etc., which have been included in the valuation, *e.g.*, liabilities for sub-contracted processes.

The tests to be made in each case must be determined by the circumstances and the records available, but such tests as the above, thought not of themselves proving the correctness of the stock, will serve to protect the auditor against any charge of negligence, should errors or fraud afterwards be discovered. Where the auditor is reasonably satisfied that the stock is correct, it is not usual for him to refer to the matter in his report; but where, owing to the nature of the business, or to the manner in which the stock has been taken, this is not the case, it is advisable for him to state in his report that he has accepted the certificate of the officials, such statement being qualified, where necessary, according to the facts of the case.

Auditors sometimes feel that where stock has been taken by an independent firm of stocktakers, or valuers, they are relieved of all responsibility in connection with this asset and may rely implicitly on the certified stock sheets produced to them. This view is quite erroneous. Whilst there is no doubt that the fact that stock has been taken and valued independently is of great assistance to the auditor, it must be realised that trade valuers can make mistakes and in any event can only take stock of such items as are produced to them. Goods for which the purchase invoices have not yet been entered or goods still on hand but actually sold may thus have been included by the valuer owing to his ignorance of these facts. All reasonable tests must, therefore, be applied by the auditor to such stock sheets.

§ 5. Loans on Security

The verification of loans on security involves not only an

examination of the loan account in the ledger, but also of the security lodged, in order that the auditor can satisfy himself that the loan is properly secured, and that there is a reasonable margin between the amount of the loan and the value of the security.

The fact that interest is regularly charged up and paid on the due dates, is additional evidence of the existence of the loan. Interest in arrear for any length of time may indicate that the account is doubtful, and where it is added to the amount of the debt, it should be seen that, if necessary, further security is lodged.

When the auditor does not consider the debt fully secured and particularly in cases where the interest is accumulating without further security being lodged, he should see that proper provision is made to cover any possible loss. Where interest has not been paid, it is sometimes left out of account altogether. This prevents the possibility of irrecoverable interest being credited to revenue, and distributed as profit. On the other hand, this treatment does not record the actual state of the loan account, and in the case of banks and other concerns whose business it is to advance money, it is usual to find that interest is regularly charged up, but when its recovery is doubtful the amount thereof is either fully provided against or taken to the credit of an Interest Suspense Account which is carried forward, and not treated as profit until the interest is actually received.

Where lending money is not part of the normal business of the concern it is suggested that the auditor should obtain confirmation from the borrower of the amount outstanding at the balance sheet date.

The nature of the security lodged against loans varies with each class of business transaction. A loan on the security of land, or any estate therein, is secured by way of a mortgage, which may either be *legal,* when an actual title to the land will be conveyed, or *equitable,* which may be effected either by a written instrument termed a memorandum of deposit, or by the mere deposit of the title deeds.

Where the loan is secured by the transfer of possession of movable assets or by the deposit of securities, the transaction is called a pledge.

The auditor's duties in connection with the verification of the

more usual classes of loans on security will now be considered.

(A) LOANS ON MORTGAGE

On the occasion of the first audit, the mortgage deed should be examined in detail, the following points being noted:

(1) The name of the party to whom the mortgage is granted. If a nominee of the client has been named as the lender (*i.e.*, as mortgagee) the auditor must obtain a certificate from such nominee acknowledging that he has no beneficial interest in the mortgage.
(2) The particulars of the property mortgaged, which should correspond with the title deeds of such property.
(3) The amount of the loan, and date thereof.
(4) The rate of interest payable.

The above details are usually endorsed on the back of the mortgage, and if the auditor has verified them on the first occasion, it will not be necessary for him to examine the deed in detail at subsequent audits.

The title deeds deposited with the mortgage deed should be examined, the same considerations applying as with the verification of freehold and leasehold properties, referred to in § 2 of this Chapter.

The last receipt for fire insurance should be produced, in order that it may be seen that the property is protected against fire, and in the case of leaseholds the last receipt for ground rent.

In order to verify the value of the property, and to see that there is sufficient margin of security, the auditor should inspect the valuer's certificate. Where the loan has been outstanding for some time, and there is any possibility that the value of the property has diminished, a further valuation should be made.

In the case of a second mortgage, the mortgage deed should be examined, and this should recite the prior charge. The title deeds will be in the possession of the first mortgagee, and the auditor will, therefore, not be able to inspect them, but an acknowledgment should be obtained from the first mortgagee or his solicitors, stating that he has received notice of the second charge.

(B) LOANS ON THE SECURITY OF INVESTMENTS

The auditor should examine the schedule of investments deposited as security for the loan, and verify the investments in the manner already described in § 3.

In the case of registered stocks, the auditor should see that the stocks have actually been transferred into the name of the lender or his nominee.

The deposit of the certificate issued to the borrower, accompanied by a blank transfer signed by him, which is not completed and registered immediately, though it may constitute an equitable charge, will not of itself afford a complete security.

The values of the securities deposited should be tested by the auditor in the manner previously indicated, in order that he may ascertain whether there is sufficient margin to secure the loan fully; and he should ascertain that the usual undertakings have been lodged to repay on demand, or at a fixed date with interest, or to deposit further security in the event of that held depreciating by reason of a fall in market values during continuance of the loan.

(C) LOANS ON OTHER SECURITY

Goods are frequently pledged for advances. Where the goods are in transit, the complete set of bills of lading, duly endorsed in favour of the lender, will be deposited, together with the insurance policy. Where the goods are at the docks, or in bonded or other warehouses, the dock warrants or warehouse certificates, endorsed in favour of the lender, will be lodged. Where warrants or certificates have not been issued, delivery orders in favour of the lender will be lodged. Delivery, however, will not be made on such orders until all the rent and other charges accrued on the goods have been paid; and the extent of any liability outstanding in this respect should be ascertained, as it may materially affect the value of the security. The auditor should test the value of the goods by reference to market quotations, invoices, etc.

In order to verify a loan on personal guarantee, if the guarantee is in writing, inspect the documents or otherwise see confirmation from the guarantor. In order to ascertain whether the loan is secured, the auditor should satisfy himself that the guarantor is good for the amount involved.

Loans on the security of life policies, though they may be fully covered in the event of the immediate death of the assured, should only be regarded as secured to the extent of the surrender value of the policies. The auditor should require the production of a statement from the insurance company, showing the surrender value, and ascertain that due notice of assignment has been given to the company. The last premium receipt should be inspected.

(D) Loans to Employees

Loans are often made by firms to their employees to assist them to purchase houses or meet other exceptional expenditure. The loan agreements or other documents signed by the employees acknowledging such loans must be inspected and the terms in respect of interest, if any, and repayment noted.

If the loans are secured the securities must be examined in the usual manner. Many loans of this description, however, are unsecured and the auditor must give due consideration to the possibility of bad debts arising.

If it has been arranged with the employee that the loan shall be repaid over a period by the deduction of a fixed weekly or monthly sum from his salary, the auditor should see that the appropriate adjustments have been made. A certificate must be obtained from each employee setting forth his indebtedness to the firm on loan account at each Balance Sheet date.

The requirements of the Companies Act, 1956, in regard to loans made to officers of a company are dealt with in Chapter IX.

(E) Loans to Subsidiary Companies

If the auditor of the holding company is also the auditor of the subsidiary company to whom a loan has been made, he will be able himself to verify from the books of the latter company the amount outstanding at the date of the Balance Sheet. If, however, the auditor of the holding company is not the auditor of the subsidiary company he must obtain a certificate as to the balance outstanding according to the books of the subsidiary company. In view of the close relationship between a holding company and its subsidiary, it is considered that the certificate required should be obtained from the auditor of the subsidiary company, rather than from a director of that company, who is probably also a

director of the holding company.

As many loans of this nature are made without security, it will frequently be necessary for the auditor to consider the possibility of a loan proving to be wholly or partially irrecoverable. The auditor should call for the last audited accounts of the subsidiary and make a personal assessment of the value of the debt.

§ 6. Bills Receivable

The balance of the Bills Receivable Account in the impersonal ledger will represent bills on hand at the date of the Balance Sheet, and if the auditor attends on that date he should inspect the actual bills. In most cases, however, the verification will take place after the date in question, and consequently, the bills that have been met subsequently will be verified by vouching the cash received. In the case of bills discounted since the date of the Balance Sheet, the receipt of the proceeds will be verified.

In examining the bills the auditor should see that they are properly drawn and stamped, and that they are not overdue. Where there is any doubt as to whether the bills will be met, inquiries should be made, and it should be seen that sufficient provision has been made for any loss likely to be sustained. Where a bill has been retired since the date of the Balance Sheet, the new bill should be seen; and where part of the original bill has been paid, it should be seen that the proceeds have been received, and that a new bill has been obtained for the balance.

Where transactions in bills are numerous, it is usual to place them in the hands of bankers or other agents for collection, and, in such cases, certificates should be obtained from them detailing the bills they held at the Balance Sheet date. It is essential that such certificates should give details of the charge, if any, the bankers or others have on the bills so held.

The auditor should see that a note of the contingent liability in respect of bills discounted outstanding appears on the Balance Sheet, and that proper provision has been made in respect thereof if necessary.

§ 7. Other Assets

(1) *Book Debts*

The verification of book debts has already been dealt with at

length in Chapter III, § 9(c).

(2) *Cash at Bank and in Hand*

The verification of cash in hand and at bank on current or deposit account, and of the petty cash balance, has been dealt with in Chapter II, §§ 6 and 7.

(3) *Endowment Policies*

Endowment policies taken out for the redemption of leases, or sinking fund policies for the redemption of debentures, and other policies of a similar nature, should be verified by inspection of the policies, and the auditor should ascertain that the last premium has been duly paid. Where such policies are shown in the Balance Sheet at values other than their surrender values the auditor should see that the surrender values are shown as a note.

(4) *Assets abroad*

Where the documents of title relating to assets abroad are not in this country, a certificate should be obtained from the agent, or other party holding the documents and the auditor should state in his report what evidence has been produced.

(5) *Plant and Machinery*

In most manufacturing businesses expenditure on plant and machinery is charged to one account under that heading, irrespective of the effective life of the machines. It will be appreciated, therefore, that to provide for depreciation on the basis of the balance on the plant and machinery account, without regard for the nature, age and cost of each machine comprising such balance, would often result in an inaccurate provision being made. In order that the asset account shall remain at cost, and the total amount of the accumulated provision for depreciation be readily ascertainable, provisions for depreciation should be credited to a Provision for Depreciation of Plant and Machinery Account, the balance on which will represent the total accumulated provision to date. Very considerable research, however, will normally be necessary to ascertain how much of the total accumulated provision for depreciation relates to any particular machine, unless a Plant Register is kept.

The Plant Register will show the cost of each machine purchased and the amount accumulated for its depreciation, and suitable entries will be made therein in respect of machines sold or scrapped. When vouching the entries made in financial books for purchases of machinery, the auditor should also vouch the corresponding entries in the Plant Register and, in due course, he should test the arithmetical accuracy and the adequacy of the provisions made therein for depreciation.

At each Balance Sheet date a list should be extracted from the Plant Register, showing in respect of each machine:

(*a*) its description or number;
(*b*) its cost;
(*c*) the provision made for the year under review for its depreciation; and
(*d*) the accumulated provision for its depreciation.

The auditor should test a representative number of the entries on this list with the Plant Register and agree the total of (*b*) with the balance on the Plant and Machinery Account and the total of (*d*) with the balance on the Provision for Depreciation of Plant and Machinery Account. The total of (*c*) will be reconciled with the debit for depreciation in the accounts for the year. The list should be certified by the works manager or other competent person as representing a complete record of all plant and machinery owned at the date of the Balance Sheet.

When machines are sold or scrapped, the auditor must satisfy himself that appropriate entries have been made to remove the cost thereof from the asset account, and the accumulated provision for their depreciation from the Provision for Depreciation of Plant and Machinery Account. Some profit or loss is almost certain to arise from the sale or scrapping of a machine and the auditor must ensure that this is dealt with correctly. In cases where provisions for depreciation are credited to the asset account and no Plant Register is kept, it may be found that the only entry made when a machine is sold is a credit to the Plant and Machinery Account for the proceeds, with the result that the balance left on the account either includes a loss incurred or has been deflated by a profit made on a machine no longer owned

and does not, therefore, represent the true written down value of the machinery still on hand.

Compliance with the requirements of the Companies Act, 1956, and the preparation of tax computations are greatly facilitated if there are recorded in the Plant Register details of different types of depreciation allowances, development rebate and written down values for tax purposes.

Where plant is revalued, either for fire insurance purposes or otherwise, the valuation should be examined by the auditor, and if it is below the book value he should ascertain the cause of the difference.

In the case of loose tools and plant, it is usual for a valuation to be taken each year, and the item treated in the same manner as stock. Where this is done, the auditor will examine the valuation sheets, and ascertain that they are properly certified.

(6) *Furniture, Fittings and Office Equipment*

The remarks made above in connection with plant and machinery also apply in many respects to furniture, fittings, etc. Few firms, however, keep a Furniture, etc., Register recording all of such assets but many keep a record of the more expensive items, *e.g.*, accounting machines, comptometers, adding machines, typewriters, etc. If such a record is kept, it is advisable for the items recorded therein to be dealt with in a separate account in the financial books and not merged in the general Furniture, Fittings, etc. Account in order that the cost of the assets and the provision for their depreciation as shown by the register can be reconciled with the balances on the relevant accounts at the Balance Sheet date.

In view of the varied nature of the items coming within the general heading of furniture, fittings, etc., the auditor must pay particular attention to the adequacy of the provision made for depreciation. It will be appreciated that the life of an accounting machine will not compare with that of a desk and that, therefore, the adoption of one rate of depreciation for all items would, normally, be unsatisfactory.

Many firms make a complete inventory of all furniture, etc., once every few years in order to satisfy themselves that their insurance cover is adequate. Where a recent inventory is available,

the auditor should list a representative number of major items shown to have been purchased during the last few years and confirm that they are included in the inventory.

As in the case of plant and machinery, the auditor must pay particular attention to the treatment of profits or losses arising from the sale of furniture, etc.

(7) *Motor Vehicles*

Where the number of vehicles owned is considerable, it is desirable that a register, similar to a Plant Register, be kept of these assets. If such a register is not used, it is essential that the make up of the balance brought down on the Motor Vehicles Account should be clearly shown thereon by indicating the registration number and cost of each vehicle comprising such balance.

The auditor will examine the registration book for each vehicle, noting that the registration number and description recorded therein agree with the particulars shown in the ledger account or Vehicles Register. If it is found that a vehicle is not registered in the client's name, the auditor must ascertain the reason for this and obtain written confirmation from the person named in the registration book that the vehicle is the property of the client and that no charge is claimed thereon.

The auditor must verify the adequacy of the provision made for depreciation and the adjustments arising from the sale or scrapping of vehicles in the same manner as outlined above in connection with plant and machinery.

(8) *Patents*

In order to verify the existence of a patent, the actual patent should be examined and it should be seen that it has been duly registered. Where the patent has been purchased, the assignment as well as the patent should be inspected. Where a considerable number of patents is held, a schedule should be presented to the auditor, containing in the case of each patent its registered number, date, description and the number of years unexpired. The last renewal certificate should also be examined, as unless this is taken out at the prescribed time, the patent will lapse. Where patents are held by a company, a resolution should be passed by the directors in respect of all patents allowed to lapse.

The question of the valuation of patents for Balance Sheet purposes has been considered in Chapter IV, § 6(B).

(9) *Copyright*

The Copyright Act, 1957, protects authors and others from infringement of their exclusive right to publish, reproduce, broadcast or in other ways to deal with their literary, dramatic, musical or artistic works. The Act also deals with the copyright in sound recordings, cinematograph films, television and sound broadcasts, etc. In the cases of literary, etc., works the copyright subsists until the end of the period of fifty years from the end of the calendar year in which the author dies. In other cases the copyright expires at the end of the period of fifty years from the end of the calendar year in which the recording, film, etc., was first published.

When a copyright has been purchased, the auditor will examine the written assignment and vouch therewith the price paid. Where, however, the client is the original author no value would, normally, be placed upon the copyright in his books and no documents of title are available for inspection. The auditor must examine all licences or assignments granted by his client and satisfy himself that all royalties, fees, etc., due thereunder have been properly accounted for. The question of the valuation of copyrights has been dealt with in Chapter IV, § 6(B).

(10) *Trade Marks*

Trade Marks are registered at the Trade Marks Registry and the auditor should examine the certificate issued by the registrar. Where a trade mark has been acquired by assignment, the amount paid therefor will be vouched with the assignment and will represent capital expenditure. Where the trade mark has been registered by the proprietor, the auditor must vouch the amounts treated as capital expenditure, *e.g.*, registration fees, payments to artists, etc., and satisfy himself that any sums capitalised in respect of staff salaries, overheads, etc., for the time devoted to the design of the mark are reasonable. Fees paid for the renewal of trade marks must be charged to revenue and the auditor must examine the last renewal receipt to ensure that the mark has not been allowed to lapse.

The Companies Act, 1956, requires the amount of goodwill, patent, trade marks and designs to appear as separate items, as far as possible, in the Balance Sheet of a limited company.

(11) *Goodwill*

Goodwill is an intangible asset and an account therefor will normally, only be found in the books of a business which has made some payment for goodwill purchased from some other firm or individual. In such circumstances, the vending agreement will be examined to ascertain the amount paid for goodwill which will be either a specified sum or the excess of the total price paid for the business acquired over the value of the net assets taken over. The real value of the goodwill of any business can be said to fluctuate almost daily and it is not part of an auditor's duty to consider whether this value is greater or smaller than its book value at a Balance Sheet date.

In partnerships the book value of goodwill may be written up or down at will, provided that all the partners are in agreement with the adjustment made. The auditor, in such circumstances, should satisfy himself that the implications of the entries made have been fully understood by all the partners and he should inspect a minute or other document agreeing thereto signed by all parties.

§ 8. Events occurring after the Balance Sheet date

The interval which elapses between the date of the Balance Sheet and the completion of the audit naturally varies considerably, but during this period events may take place which have some bearing on the values placed on the assets or the amounts of the liabilities included in the Balance Sheet. It must be remembered. however, that the purpose of a Balance Sheet is to show the financial position of the business *as at the date of such Balance Sheet* and that, therefore, matters which arise after that date, however important they may be, cannot be dealt with in the Balance Sheet unless they are such as to show that the first draft was, in fact, incorrect. Thus, if a property owned by a company was destroyed by fire on 15th February—a date prior to the completion of the audit—this would not justify and amendment of the Balance Sheet dated the preceding 31st December, even though the property was uninsured and a substantial loss had resulted. Such a matter

would be the concern of the directors who should communicate the facts to the share-holders in their report [Section 217 (1)].

Many matters may arise, however, before the audit is completed, which show that estimates or valuations made at the Balance Sheet date were wrong *at that date*. Regard must be had for events of this nature and the auditor should see that the appropriate adjustments have been made in the Balance Sheet. Examples of such matters are:

(*a*) Provision for liabilities, the precise amount of which cannot be ascertained, must normally be made at a Balance Sheet date. Such provisions are estimates and subsequent events may prove them to have been inadequate or excessive. The after-acquired information must be used to adjust the amount of the provision if the difference is material.

(*b*) Changes in taxation may take place after the date of the Balance Sheet which affect the provisions for taxation made therein. The provisions should be adjusted to give effect to the new taxation position.

(*c*) The provision at a Balance Sheet date for bad and doubtful debts must necessarily be made on an estimated basis. It may be, however, that before the audit is completed certain debts which were regarded as bad are paid in full, whilst others, deemed to be good, prove to be irrecoverable. These events show what was the real value of the debts in question *at the Balance Sheet date* and the necessary adjustments must be made to the provision created.

The recommendations of the Council of the Institute of Chartered Accountants in England and Wales on this matter are given hereunder.

Events which, at the time of preparing annual accounts, are known to have occurred after the Balance Sheet date, should not normally be taken into account in preparing accounts unless:

(*a*) they assist in forming an opinion as to the amount properly attributable, in the conditions existing on the Balance Sheet date, to any item the amount of which was subject to uncertainty on that date; or

(*b*) they arise from legislation affecting items in the accounts, for example changes in taxation, or are required by law to be shown in the accounts, for example appropriations and proposed appropriations of profits.

CHAPTER VI

THE BALANCE SHEET AUDIT

§ 1. Introduction

The method of auditing which has been described in the preceding chapters can be summarized as follows:

(1) Original entries in day books and cash books are vouched and the costs of such books checked or tested.
(2) The postings from the books of prime entry to the appropriate ledger accounts are checked or tested.
(3) Ledger balances are checked and, in the cases of Sales and Bought Ledgers, agreed with schedules on debtors and creditors, and with the Trial Balance in the cases of the Private and Impersonal Ledgers.
(4) Sales Ledger balances are examined from the viewpoint of possible bad or doubtful and the balances on the Bought Ledger confirmed by reference to creditors' statements, etc.
(5) The provisions made for outstandings at the Balance Sheet date are subjected to careful scrutiny.
(6) The items appearing in the Trading and Profit and Loss Account and Balance Sheet are agreed with the Trial Balance and the schedule of adjustments required for outstandings, etc.
(7) The ownership and continued existence of the assets appearing in the Balance Sheet are verified and due regard is paid to the adequacy of the provisions made for depreciation.

A detailed audit thus starts with the books of prime entry and ends with the Balance Sheet, the sequence of checking following the order in which the entries are made.

This procedure is satisfactory when applied to the audit of the accounts of small and medium sized concerns, especially when the books are kept by hand-written methods. In larger cases, however, particularly when the records are mechanised, the 'vouch

and post' audit is often unsatisfactory, if not impracticable, for the following reasons:

(*a*) A large volume of transactions requires a considerable amount of summarisation and posting of totals to other summaries, with the result that it is frequently difficult to appreciate the ultimate effect of the entry under examination.

(*b*) Links in the chain of records which extends from prime entry to private ledger may either be missing entirely or be presented in a very attenuated form, *e.g.*, by means of a mechanised list summarising an accompanying file of documents.

(*c*) If the financial and cost accounts are integrated, it will be impossible to trace expenditure on materials, wages and over-heads directly to the impersonal ledger. In these circumstances it will be found that almost all expenditure is posted to one or more control accounts and that the vast majority of entries in the impersonal ledger are made from costing abstracts which are based on materials requisitions, wage allocations and summaries of overhead expenses. The link between outgoings on the one hand and the ultimate ledger accounts on the other will be provided by the following records:

(i) *Purchases of raw materials*: the stores ledger, materials requisitions and the costing summaries.

(ii) *Wages*: the wages control account, time sheets or clock cards and the wages allocations.

(iii) *Overhead Expenses*: the overhead expenses control account (which may be divided so as to provide separate control accounts for works, selling and administrative expenses) and summaries and abstracts of expenditure.

(*d*) The system of internal check, coupled possibly with an internal audit, is normally adequate enough to make the exhaustive checking of original entries less important.

(*e*) The volume of transactions may be so great that it is impossible for more than a small proportion of the routine account-

ing entries to be checked by conventional methods, if the audit is to be completed in a reasonable time and at a reasonable fee.

For the reasons enumerated above, and an increasing realisation of the fact that the importance of checking arithmetical accuracy must be kept in its right perspective, there has been a growing tendency in recent years to carry out what is usually termed a "Balance Sheet Audit." This type of audit starts with the verification of the items appearing in the Balance Sheet and involves only such an examination of original entries and vouchers as the auditor feels to be necessary in the circumstances.

§ 2. The Relationship of Balance Sheet and Profit and Loss Account

It will be appreciated that every transaction has an ultimate effect on the Balance Sheet. Some transactions affect both the Balance Sheet and the Profit and Loss Account but others merely result in a variation in certain Balance Sheet items, thus:

(*a*) The payment of a liability reduces the *asset* "cash at bank" and the *liability* "creditors" by the same amount.
(*b*) The collection of a sum due results in a reduction in the *asset* "debtors" and a corresponding increase in the *asset* "cash at bank."
(*c*) The purchase of a fixed asset increases the appropriate "fixed asset" account and either reduces the *asset* "cash at bank" or increases the *liability* "creditors."
(*d*) The issue of debentures for cash results in an increase in the *asset* "cash at bank" and a similar increase in fixed *"liabilities."*

The majority of transactions, however, affect both the Balance Sheet and the Profit and Loss Account as will be seen from the examples of the ultimate effect of normal trading transactions given below.

(*a*) The sale of goods on credit at a profit increases the *asset* "debtors" by the selling price, reduces the *asset* "stock" by

the cost price and increases the balance on the Profit and Loss Account by the profit earned.

(*b*) The payment of salaries reduces the *asset* "cash at bank" and the balance on the Profit and Loss Account.

(*c*) Provisions made for depreciation of fixed assets reduce the net values at which such assets appear in the Balance Sheet and the balance on the Profit and Loss Account, but do not reduce the liquid resources of the business.

(*d*) The receipt of bank interest increases the *asset* "cash at Bank" and the balance to the credit of Profit and Loss Account

It must also be realized that any under or overstatement of an asset or liability will normally have a corresponding effect on the balance of the Profit and Loss Account. For example, an overvaluation of stock results in an overstatement of profit; an excessive provision for an outstanding liability deflates profit; the omission from trade creditors of a supplier's invoice for goods taken into stock inflates profit.

It should, therefore, be appreciated that the verification of the accuracy of the assets and liabilities appearing in the Balance Sheet, coupled with a careful analysis of the changes which have taken place therein since the previous Balance Sheet, also does much to prove the accuracy of the Profit and Loss Account.

§ 3. The Programme for a Balance Sheet Audit

If the auditor is satisfied that the system of internal check in operation is adequate, and it has been shown by the tests he has made of the detailed entries to be working satisfactorily, he may feel justified in carrying out a Balance Sheet audit. The following are the principal items to be included in the programme for such an audit. It will be seen that each is of such a nature that it can only be performed by a skilled accountant; work of this description cannot be delegated to clerks who do not possess the technical knowledge and the experience required to make the appraisals which are called for.

(1) Compare each item in the Trading and Profit and Loss Account with the corresponding item for the previous year

and ascertain the reasons for any material variations.

(2) Consider whether increases or decreases in wages, materials consumed and variable expenses appear to be proportionate to the increase or decrease in turnover. Ascertain the quantities of turnover where the money values have been inflated or deflated by price changes, alterations in rates of purchase tax, customs duties, etc.

(3) Obtain a satisfactory explanation for any material change in the rate of gross profit earned.

(4) Ascertain the reason for any substantial increase or decrease in the net profit for the period compared with that recorded for the previous period.

(5) Scrutinise any exceptional transactions or items of a non-recurring nature which have resulted in charges or credits of a material amount to the revenue of the period.

(6) Consider the effect of the recorded profit on the position disclosed by the Balance Sheet, *e.g.*, does this reveal increased liquidity, a reduction in capital or long-term liabilities or increases in fixed assets?

(7) Compare the value of stocks on hand with the cost of turnover and enquire into any material change in the ratio. Compare such values with those adopted for insurance purposes.

(8) Examine the schedules showing the composition of each item appearing in the Balance Sheet and compare such items with the corresponding figures for the previous period. Consider carefully all material changes.

(9) If the total due by trade debtors is disproportionate to turnover, as compared with the corresponding figures for the previous year, ascertain the reason for this. If it is found that longer credit appears to have been taken by customers, pay exceptional attention to the provisions for bad and doubtful debts and the possibility that remittances have not been accounted for. If sales of an exceptional amount are recorded towards the end of the period, make certain that the sales in question are properly attributable to the period under review and examine the returns for the ensuing period.

(10) Consider the total shown to be due to trade creditors in

relation to the turnover for the period, the value of stocks on hand and the period of credit normally taken.

(11) Compare the schedules of outstandings and provisions with those for the previous period and enquire into any material changes.

(12) Scrutinise the minute books for any references to matters affecting the accounts, *e.g.*, capital commitments, litigation, commissions payable under service agreements, capital issues etc.

(13) Consider the values placed on current assets.

(14) Consider the reasonableness of all provisions made for depreciation and, where appropriate, compare them with the capital allowances granted for taxation.

(15) Ascertain whether there have been any changes in the basis of accounting which have resulted in a material increase or decrease in the recorded profit.

(16) Make all necessary enquiries to determine the amounts and nature of any contingent liabilities and commitments for capital expenditure not provided for in the accounts and ascertain the extent of any contracts for forward purchases or sales. In the cases of forward contracts, consider whether any provision for anticipated losses is required at the Balance Sheet date.

(17) Examine carefully the adjustments made in the taxation computations. See that any amounts added back which come within (5) above have been properly dealt with.

(18) Where appropriate, compare with the accounts concerned the figures shown by certificates and returns made to trade associations, insurance companies etc., in respect of wages and salaries paid, declarations for insurance purposes, sales tax returns, returns to Customs and Excise authorities and similar documents.

(19) Verify in the usual manner the assets and liabilities shown in the Balance Sheet.

It must, of course, be emphasised that where such a programme is followed it must not be overlooked that an apparently satisfactory position may, in fact, be the result of compensating factors.

§ 4. Audit Working Papers

In addition to his permanent file and audit programme, it is essential in the case of a Balance Sheet audit for the auditor to prepare a full set of detailed schedules forming a fully documented summary of the books of account. For each class of asset and liability a separate schedule should be prepared, each of which should be supported by supplementary schedules reconciling the particular asset or liability under consideration with the corresponding figure in the previous Balance Sheet and thus providing an epitome of the transactions affecting the account during the period.

The entries in the schedule should be carefully cross indexed so that it can readily be seen, for example, that the amount credited to the Provision for Depreciation Account is the same as that charged in the Profit and Loss Account, or, if it is not, that the reason for the difference is explained by the appropriate schedule. An example of typical working papers, covering fixed assets, depreciation and debtors is given below:

PQR LTD.

AUDIT WORKING PAPERS

Year to 31st December, 19..

Fixed Assets at Cost *Schedule A*

	Land and Buildings Rs.	Plant Rs.	Vehicles Rs.
Balance per previous Balance Sheet	1,75,000	2,40,000	1,60,000
Additions at cost per Schedule A. 1	24,000	60,000	18,000
	1,99,000	3,00,000	1,78,000
Less: Assets sold, etc., per Schedule A. 2 ..	7,000	11,000	4,000
	Rs. 1,92,000	2,89,000	1,74,000

Schedule of Assets purchased *Schedule A.* 1

Land and Buildings

(*a*) Deposit on land (authorised by Minute of 15th November, 19..)	Rs. 4,000
(*b*) Purchase of house (Minute 24th September, 19..) ..	20,000
Per Schedule A	Rs. 24,000

(*a*) Completion of land purchase to be made 15th January, 19.. Balance per shedule of capital commitments (R 3) Rs. 36,000 Contract inspected by J. B

(*b*) Purchase of House:

Contract and completion statement inspected and adjustments for accruals verified by J. B.
Fire insurance policy inspected by J. B.
Deeds inspected at bank by L. M. R.

Plant and Machinery

Per Capital orders (wages, materials and works overheads):

C.O. 72. New machine (Minute 14th January, 19..) ..	Rs. 48,000
73. Extension to Machine 24 (Minute 15th February, 19..)	10,000
74 Foundation for new P Machine ..	2,000
Per Schedule A .	Rs. 60,000

Note: P machine is expected to cost Rs. 17,000
Ordered 15th December, 19.. ..

This item requires the approval of the Board.

Balance per schedule of Capital Commitments (R. 3) . Rs. 17,000

Checked with Plant Register by J. B.

Motor Vehicles

New Van AB 9999 (purchased 30th June, ...)	Rs. 11,000
New car AB 8888 (purchased 1st January, ...)	7,000
Per Schedule A	Rs. 18,000

Checked with Vehicles Register by J. B.

Registration books inspected by J. B.

Schedule of Assets Sold, Scrapped, etc. *Schedule A.* 2

Land and Buildings

Claim for destruction by fire	Rs. 6,500
Loss (transferred to Depreciation, Schedule D. 1)	500
Per Schedule A.	Rs. 7,000

Insurance claim and settlement examined by L. M. R.

Plant and Machinery

Sale of machine 21 (cost Rs. 11,000)	Rs. 8,000
Accumulated depreciation written back from Provision for Depreciation Account (Schedule R. 2)	2,500
Loss (Schedule D. 1)	500
Per Schedule A	Rs. 11,000

Checked with Plant Register by J. B.

Motor Vehicles

Sale of van AB 7777 (cost Rs. 4,000)	Rs. 2,250
Accumulated depreciation written back (Schedule R. 2)	2,000
	Rs. 4,250
Profit on sale (Schedule D. 1)	250
Per Schedule A	Rs. 4,000

Checked with Vehicles Register by J. B.

Depreciation and Obsolescence *Schedule D.* 1

On assets 31-12-19..	
Land and buildings	nil
Plant: 10% on cost	Rs. 24,000
Vehicles: 25% on cost	40,000
On additions during the year (A. 1):	
Land and buildings	nil
Plant C. O. 72. 10% for 6 months	2,400
73. 10% for 3 months ..	250
74. — . ..	nil
Motor Vehicles (A. 1):	
A B 9999 25% for 6 months . .	1,375
A B 8888 25% for 12 months	1,750
Per Schedule R. 2 . ..	69,775
Loss on fire claim (A.2)	500
Loss on sale of Machine 21 (A.2)	500
	70,775
Less: Profit on sale of van AB. 7777	250
Per Profit and Loss Account	Rs. 70,525

Provision for Depreciation *Schedule R.* 2

	TOTAL	PLANT	VEHICLES
	Rs.	Rs.	Rs.
Balance per last Balance Sheet ..	1,65,000	75,000	90,000
Charge for the year (D. 1)	69,775	26,650	43,125
	2,34,775	1,01,650	1,33,125
Less: Accumulated depreciation on assets displaced .	4,500	2,500	2,000
Per Balance Sheet ..	Rs. 2,30,275	99,150	1,31,125

Checked with Plant and Vehicles Register by J. B.

Schedule of Capital Commitments *Schedule R.* 3

Purchase of land (A. 1)	Rs. 36,000
New P. Machine (A. 1)	Rs. 17,000
Per note to Balance Sheet	Rs. 53,000

DEBTORS *Schedule C. 1*

DEBTORS	Debtors outstanding for a period exceeding six months				Other Debtors				Grand Total
	Good	*Doubtful*	*Bad*	*Total*	*Good*	*Doubtful*	*Bad*	*Total*	
Sales Ledger Accounts (*per summary D.* 2)									
Secured	2,40,000	..	..	2,40,000	4,50,000	.	..	4,50,000	6,90,000
Partly Secured ..	10,000	.	..	10,000	30,000		.	30,000	40,000
Unsecured	.	800	200	1,000	20,000	2,000	1,000	23,000	24,000
	2,50,000	800	200	2,51,000	5,00,000	2,000	1,000	5,03,000	7,54,000
Debit Balances on Bought Ledger Accounts (*per summary D.* 3)									
..Secured . ..	..		.	.	.		..	..	
..Partly Secured ..	.	..	.	..	.			..	
Unsecured		100		100	..	250	.	250	350
	2,50,000	900	200	2,51,100	5,00,000	2,250	1,000	5,03,250	7,54,350

Less: Provision for Bad Debts									
Last Year's Provision	5,000								
Less:—Written Off	2,000								
	3,000								
Current Year's Provision ..	1,350								
	4,350	..	900	200	1,100	.	2,250	1,000	3,250	4,350
Per Balance Sheet ..		2,50,000	..	..	2,50,000	5,00,000	..	..	5,00,000	7,50,000

Notes:— (*i*) The balances of Ledger A—C checked to schedule by A. B.

(*ii*) All debts appearing bad have been written off.

(*iii*) All sales ledger debtors circulated with audit statement. No material discrepancies revealed.

Notes:— (*i*) Schedules D. 2, D. 3 and P. 1 are not given.

(*ii*) The sales and bought ledger control accounts might be included in the working papers in summary form so that the causes of the variation in Sales and Bought Ledger balances during the period under review are clearly revealed.

It will be observed that a perusal of the working papers will bring the transactions into focus so that the content of the items appearing in the accounts can be understood.

If the additions to plant are fabricated in the company's own workshops, each capital order will consist of labour, materials and overhead allocations, based on wage abstracts, requisitions and overhead expense summaries. Although the auditor can, and should, test a proportion of those documents, noting the code number and the certification of each, he will not obtain such a clear picture of the nature and purpose of the expenditure as by the method of 'working backwards' indicated above. Each capital order can be substantiated by Board minute or by engineer's certificate, and the auditor can call for the various internal documents making up the total.

The principles of valuation of assets are unchanged under the Balance Sheet audit and each must be verified in the normal way. In fact this method of approach places greater emphasis on verification.

§ 5. Detailed Checking

It cannot be too strongly emphasised that a careful consideration of the adequacy of the system of internal check is of paramount importance in determining the programme to be followed in the audit of large undertakings and the auditor should obtain a written statement of the procedures adopted. If there is an internal audit department, the auditor should obtain copies of their programme and periodical reports. In the light of these, the auditor will be able to appraise the effectiveness of the system of internal check and plan his own audit programme accordingly.

If the auditor is satisfied that the system of internal check ensures that errors are brought to light and rectified and that it provides an adequate safeguard against fraud, it is clearly unnecessary for him to check every posting and cast and vouch every entry in the books. It will be appreciated, however, that any reduction he makes in his detailed checking is the auditor's own responsibility and that, therefore, the accuracy of his appraisal of the effectiveness of the internal check is a matter of the greatest importance.

When the auditor decides to confine his checking of details to a

series of tests, he must ensure that a representative number of transactions are checked through from the primary records to their final destination in the accounting system. For example, all purchases for a short period may be vouched in detail, the receipt of the goods being traced to the goods inwards books and stores ledger accounts, if any. The invoices should be compared with the copy orders and the prices tested with tenders, quotations or price lists. A batch of requisitions should be checked to the stores ledger and enquiries made as to the certification thereof. These requisitions should be traced to the materials abstracts, particular attention being paid to the codings appearing on the forms. The method of allocating overhead expenses should be investigated, the loading for overheads added to capital and service orders being noted.

For the same period, the system of invoicing should be examined and attention paid to any reconciliations of quantities of raw materials purchased with the quantities of finished products sold. The allowances for wastage should be examined and comparisons made, if possible, between one factory and another or between one period and another.

The method of authorising the dispatch of goods from the premises must be ascertained and the danger of goods being dispatched without being invoiced (either fraudulently or by error) should be assessed. The wage system should be investigated and a proportion of the time sheets or clock cards examined and used as vouchers for the earnings recorded for the employees. The safeguards against the inclusion of "dummy men" should be examined and the extent of the collusion which would be necessary to perpetrate this type of fraud considered. Periodically the names on the pay roll should be compared with the file of new and discharged employees kept in the personnel department and with the register of the superannuation scheme if one is in force. Any discrepancies should be carefully enquired into.

The detailed examination of the transactions of a comparatively short period will give the auditor a greater insight into the methods and procedures and the personnel employed than would a more superficial check of a longer period.

When the audit programme provides that the checking of any record shall be limited, say to two selected months in each year,

care must be taken to ensure that this, of itself, does not increase the possibility of faud. For example, if different months are taken each year, the clients' staff will know which months will be free from the auditor's scrutiny next year. One of the two months checked last year should, therefore, on occasion, be selected again for the current year.

CHAPTER VII

THE AUDITOR OF A LIMITED COMPANY

§ 1. The Appointment and Remuneration of Auditors

The majority of the audits undertaken by Professional Accountants are those of limited companies and it is, therefore, essential that the auditor should be fully conversant with the provisions of the Companies Act, 1956, relating to his appointment, duties and rights.

(A) Qualifications and Disqualifications of an Auditor

The auditor of a company must possess the qualifications prescribed by Section 226(1) and (2), Companies Act, 1956, which are given hereunder:

(1) A person shall not be qualified for appointment as auditor of a company unless he is a chartered accountant within the meaning of the Chartered Accountants Act, 1949:

Provided that a firm whereof all the partners practising in India are qualified for appointment as aforesaid may be appointed by its firm name to be auditor of a company, in which case any partner so practising may act in the name of the firm.

(2) (a) Notwithstanding anything contained in sub-section (1), but subject to the provisions of any rules made under clause (*b*), the holder of a certificate granted under a law in force in the whole or any portion of a Part B State immediately before the commencement of the Part B States (Laws) Act, 1951 or of the Jammu and Kashmir (Extension of Laws) Act, 1956, as the case may be, entitling him to act as an auditor of companies in the territories which, immediately before the 1st November, 1956, were comprised in that State or any portion thereof, shall be entitled to be appointed to act as an auditor of companies registered anywhere in India.

(*b*) The Central Government may, by notification in the Official Gazette, make rules providing for the grant, renewal, suspension or cancellation of auditors' certificates to persons in the territories which, immediately before the 1st November, 1956, were comprised in Part B States for the purposes of clause (*a*), and prescribing conditions and restrictions for such grant, renewal, suspension or cancellation.

The object of Section 226 is to ensure that (i) an auditor possesses adequate educational qualifications for the profession of

accounting and (ii) he is independent of all influences, controls and personal interest in the company.

An auditor must possess either of the following two qualifications, namely:

(i) he is a Chartered Accountant within the meaning of the Chartered Accountants Act, 1949. Section 4 of this Act gives power to the Council or the Central Government to recognise foreign qualifications to enable a person to become a member of the Institute. A 'Chartered Accountant' means a person who is a member of the Institute. A firm, whereof all the partners practising in India are qualified as aforesaid, may be appointed by its firm name to be an auditor of a company, in which case any partner so practising may act in the name of the firm. Or,

(ii) he is a holder of a certificate under the Restricted Auditors Certificates (Part B States) Rules, 1956. Such certificate entitles him to act as an auditor anywhere in India. The Central Government may, by notification in the Official Gazette, make rules providing for the grant, renewal, suspension or cancellation of such certificates and may prescribe conditions and restrictions for such purposes.

Disqualification

Section 226(3) prescribes that the following persons shall not be eligible for appointment as auditor of a company:

(i) a body corporate;

(ii) an officer or employee of the company; [vide Section 2(30)—definition of an officer which, inter alia, includes a director];

(iii) a partner or employee of an officer or employee of a company;

(iv) a person who is indebted to the company for an amount exceeding Rs. 1,000 or who has given any guarantee or provided any security in connection with the indebtedness of a third party to the company for an amount exceeding Rs. 1,000;

(v) director or member of a private company, or a partner of a firm, which is the managing agent or the secretaries and treasurers of the company;

(vi) a director or a holder of shares exceeding five per cent. in nominal values of the subscribed capital of any body corporate which is the managing agent or the secretaries and treasurers, of the company. In computing such holdings, shares held as nominee or trustee for a third person and in which he has no beneficial interest shall be excluded;

(vii) if he is disqualified, for appointment, under any one of the above six clauses as auditor of any body corporate which is (a) that company's subsidiary or (b) its holding company or (c) a subsidiary of its holding company or (d) would be so disqualified if the body corporate were a company.

In Section 226(3), references to an officer or employee shall be construed as not including references to an auditor.

A Chartered Accountant is also subject to the disabilities prescribed under Section 8 of the Chartered Accountants Act, 1949.

If an auditor after his appointment becomes subject to any of the above seven disqualifications he shall be deemed to have vacated his office forthwith.

In view of the uncertainty as to whether some of the duties often undertaken by accountants on behalf of the company might disqualify them or their partners from acting as the company's auditors, the Institute of Chartered Accountants in England and Wales obtained Counsel's opinion as to the position where an accountant acts in any of the following capacities. The opinion is summarised hereunder:

(i) *Registrar*
A registrar is not an officer of the company provided that his contract with the company is "for services" and not "of service."

(ii) *Financial Adviser*
A financial adviser or consultant is not a servant of the company unless the company has the right to control his services.

(iii) *Employee of Auditor*
An accountant is not disqualified from appointment as auditor of a company by reason of the fact that his em-

ployee acts as a director, secretary or otherwise as an officer of the company.

(iv) *Liquidator or Receiver*

The appointment of an accountant as liquidator or receiver of a company does not disqualify him or his partner from appointment as auditor of a subsidiary, holding company or fellow subsidiary of that company or, in the case of a receiver, as auditor of the company itself. If, however, an accountant is appointed *receiver and manager* of a company, he will be an officer of the company and the disqualification will, therefore, apply.

Under Section 21, the Chartered Accountants Act, 1949, read with the First and the Second Schedules to the said Act, a chartered accountant may become liable for disciplinary action for professional misconduct. This topic is dealt with in detail in § 8 of Chapter XII.

(B) APPOINTMENT OF AUDITORS

The appointment of auditors is dealt with in Section 224, Companies Act, 1956, the provisions of which are as under:

(1) Every company shall, at each annual general meeting, appoint an auditor or auditors to hold office from the conclusion of that meeting until the conclusion of the next annual general meeting and shall, within seven days of the appointment, give intimation thereof to every auditor so appointed, unless he is a retiring auditor.

(1*A*) Every auditor appointed under sub-section (1), unless he is a retiring auditor, shall within thirty days of the receipt from the company of the intimation of his appointment, inform the Registrar in writing that he has accepted, or refused to accept, the appointment.

(2) At any annual general meeting, a retiring auditor, by whatsoever authority appointed, shall be re-appointed, unless—

(*a*) he is not qualified for re-appointment;

(*b*) he has given the company notice in writing of his unwillingness to be re-appointed;

(*c*) a resolution has been passed at that meeting appointing somebody instead of him or providing expressly that he shall not be re-appointed; or

(*d*) where notice has been given of an intended resolution to appoint some person or persons in the place of a retiring auditor, and by reason of the death, incapacity or disqualification of that person or of all those persons, as the case may be, the resolution cannot be proceeded with.

(3) Where at an annual general meeting no auditors are appointed or re-appointed, the Central Government may appoint a person to fill the vacancy.

(4) The company shall, within seven days of the Central Government's power under sub-section (3), becoming exercisable, give notice of that fact to that Government; and, if a company fails to give such notice, the company, and every officer of the company who is in default, shall be punishable with fine which may extend to five hundred rupees.

(5) The first auditor or auditors of a company shall be appointed by the Board of directors within one month of the date of registration of the company; and the auditor or auditors so appointed shall hold office until the conclusion of the first annual general meeting:

Provided that—

(*a*) the company may, at a general meeting, remove any such auditor or all or any of such auditors and appoint in his or their places any other person or persons who have been nominated for appointment by any member of the company and of whose nomination notice has been given to the members of the company not less than fourteen days before the date of the meeting; and

(*b*) if the Board fails to exercise its powers under this sub-section, the company in general meeting may appoint the first auditor or auditors.

(6) (*a*) The Board may fill any casual vacancy in the office of an auditor; but while any such vacancy continues, the remaining auditor or auditors, if any, may act:

Provided that where such vacancy is caused by the resignation of an auditor, the vacancy shall only be filled by the company in general meeting.

(*b*) Any Auditor appointed in a casual vacancy shall hold office until the conclusion of the next annual general meeting.

(7) Except as provided in the proviso to sub-section (5), any auditor appointed under this section may be removed from office before the expiry of his term only by the company in general meeting, after obtaining the previous approval of the Central Government in that behalf.

The auditor of a company shall ordinarily be appointed by the company in general meeting. The tenure of his office extends from the conclusion of the meeting in which he is appointed to the conclusion of the next general meeting. When a company so appoints an auditor, other than the retiring auditor, it shall give intimation thereof to the auditor, within seven days of the appointment. Under Section 224(1A), an auditor appointed under Section 224(1), unless he is a retiring auditor, should inform the Registrar, in writing, of his acceptance or refusal within thirty

days of the receipt of the intimation. Such intimation should be given in Form No. 23B of the Companies (Central Government's) General Rules and Forms, 1956, which is as under:

Registration No. of Company .....

Nominal Capital Rs. .....

THE COMPANIES ACT, 1956

Notice by Auditor

Pursuant to section 224(1A)

I/We ..... hereby give notice to the Registrar of Companies ..... pursuant to section 224(1A) of the Companies Act, 1956, that I/We have received intimation dated the ..... day of ..... 19 .... from .... Limited/Private Limited of my/our having been appointed as auditor(s) for the year ..... and that I/We have accepted / refused to accept the appointment as auditor(s) of the company.

Dated the ..... day of ..... 19.... (a)

Signature

(a) Where the signatory is a partner of a firm of Chartered Accountants, the name of the firm also is to be indicated.

First Auditors

The Board of directors are empowered to appoint the first auditors of a company who shall hold office until the conclusion of the first annual general meeting. Such power must be exercised by the Board within one month of the date of registration of the company. If the Board fails to exercise this power, the company in general meeting may appoint the first auditors.

Compulsory Re-appointment

At any annual general meeting, the retiring auditor, by whatever authority appointed (Board, general meeting, annual general meeting or Central Government) shall be re-appointed except in the following 'cases':

(i) if he is not qualified for re-appointment;
(ii) if he has given a notice in writing of his unwillingness to be re-appointed;
(iii) a resolution is passed to the effect that he shall not be re-appointed or that somebody else be appointed in his place;
(iv) where notice has been given of an intended resolution to appoint someone else and the resolution cannot be proceeded with on account of death, incapacity or disqualification of the proposed auditor.

In the case of Government companies, special provisions have been made by Section 619. The auditor of such a company shall be appointed or re-appointed by the Central Government on the advice of the Comptroller and Auditor General of India who is also given power to direct the manner in which the audit shall be conducted and to conduct supplementary or test audit, etc.

Casual Vacancy

Where at an annual general meeting, no auditors are appointed or re-appointed, the Central Government may appoint a person to fill the vacancy. In case of such vacancy the company shall give notice to the Central Government within seven days of such power becoming exercisable and in case of default the company shall be punishable with a fine which may extend to Rs. 500.

The Board may fill any casual vacancy, arising otherwise than by resignation, in the office of auditor. However, the casual vacancy arising out of resignation shall be filled only by the company in general meeting. While such vacancy continues, the remaining auditors, if any, may act. An auditor appointed to fill a casual vacancy shall hold office until the conclusion of the next annual general meeting.

(c) THE AUDITOR'S REMUNERATION

The general rule is that the authority appointing the auditors

is authorised to fix the remuneration. By Section 224(8), the remuneration of the auditors of a company—

(*a*) in the case of an auditor appointed by the Board or the Central Government, may be fixed by the Board or the Central Government, as the case may be; and
(*b*) subject to clause (*a*), shall be fixed by the company in general meeting or in such manner as the company in general meeting may determine.

For this purpose, the expression, "remuneration" includes any sums paid by the company in respect of the auditors' expenses. The profit and loss account shall further contain or give by way of a note detailed information in regard to the amounts paid to the auditor, whether as fees, expenses or otherwise for services rendered—

(*a*) as auditor; and
(*b*) in any other capacity.

[vide Schedule VI Part II Clause 4B].

In those cases where the exact remuneration cannot be determined at the date when the accounts are completed, the Council of the Institute of Chartered Accountants in England and Wales recommend that "an estimated amount should be included in the accounts, and any subsequent adjustment, if material, in respect of the estimated amount previously disclosed, should be shown in the accounts of the following period."

In many cases in practice, the auditors charge an inclusive fee for auditing the company's books and other works *e.g.*, secretarial, taxation and accountancy matters. In these circumstances, the fee should be apportioned, the remuneration for the auditor's duties under the Act being separately specified.

(D) THE REMOVAL OF AUDITORS

When the first auditors of a company are appointed by the directors prior to the first annual general meeting, such auditors may be removed by the members in general meeting. The general meeting may, in their place, appoint any other person whose no-

mination notice has been given by any member not less than fourteen days before the date of the meeting. Such power to remove the auditor may be exercised in respect of all or any of the auditors.

In any other case, any auditor may be removed from office, before the expiry of his term, only by the company in general meeting after obtaining the previous approval of the Central Government [Section 224 (7)].

Section 225, makes special provisions in respect of a resolution appointing a person other than a retiring auditor or for providing expressly that a retiring auditor shall not be re-appointed. Special notice of the intention to move such resolution must be given, to the company by a shareholder, not less than fourteen clear days before the annual general meeting. On receipt of such notice a company must forthwith send a copy thereof to the retiring auditor.

If he wishes to do so, the retiring auditor, after receipt of the notice intimating that a resolution is to be moved appointing another person in his place or that he shall not be re-appointed auditor of the company, may make representations to the company in writing (not exceeding a reasonable length) and ask for such representations to be sent to the members of the company. On receipt of such representations the company, must unless it is too late to do so—

(*a*) state the fact that such representations have been made in any notice of the resolution sent to members; and
(*b*) send a copy of he representations to every member of the company to whom notice of the meeting is sent (whether before or after receipt of the representations by the company)..

If a copy of the representations is not sent to the members, either because it was received too late to do so, or because of default by the company, the auditor may insist that the representations shall be read out at the meeting. The Act provides, however, that copies of the representations need not be sent out, and the representations need not be read out at the meeting if, on the application either of the company or of any other person who

claims to be aggrieved, the Court is satisfied that the rights conferred upon the auditor by Section 225 are being abused to secure needless publicity for defamatory matter. In these circumstances, the Court may order the company's costs on an application to be paid in whole or in part by the auditor, notwithstanding that he was not a party to the application. The above procedure is applicable also to the removal of the first auditor under Section 224 (5) and the removal of an auditor before the expiry of his term under Section 224 (7).

It must, of course, be remembered that in addition to his right to make written representations, the retiring auditor has the power to attend the annual general meeting at which his removal is to be proposed and to address the members.

It will be observed that although the directors have power to appoint the first auditors before the first annual general meeting, such auditors can be removed by resolution of the company in general meeting, and in this way the ultimate right of appointment rests with the members in every instance, with the exception of a casual vacancy arising otherwise than by resignation. This emphasises the fact that the auditor is responsible to the members, and acts on their behalf, and not on behalf of the directors. In actual practice, as the directors are agents for the members in conducting the affairs of the company, the auditor will naturally come into personal contact with them in the course of his duties, and he will sometimes meet directors who seem to consider that the auditor exists merely to seal with his official approval the accounts presented by the Board; but it must be remembered that the auditor is the representative of the members, and his statutory duties are owed to them.

Special provisions for the appointment of an auditor, other than the retiring auditor, were first introduced by the Companies Act, 1913, owing to the method, sometimes adopted by directors, where there was a difference of opinion between the retiring auditor and themselves, of nominating another auditor without notifying the retiring auditor of their intention so to do, and carrying the appointment of the new auditor by means of the proxies at their disposal. Such procedure was in many cases detrimental to the general interests of the members, and was certainly a very poor reward for the auditor who had too faithfully discharged

his duties to them. The fact that notice must be sent to the retiring auditor, and to all members prior to the general meeting, in the event of any auditor other than the retiring auditor being nominated, prevents any alteration in the appointment without the knowledge of all the members.

The right to make written representations was conferred upon the retiring auditor for the first time by the Companies Act, 1956.

Before accepting an appointment as an auditor, a chartered accountant should specially bear in mind the clauses (8) and (9) of the First Schedule to the Chartered Accountants Act, 1949, which are as under:

(8) accepts a position as auditor previously held by another chartered accountant or a restricted State auditor without first communicating with him in writing;

(9) accepts an appointment as auditor of a company without first ascertaining from it whether the requirements of section 226 of the Companies Act, 1956, in respect of such appointment have been duly complied with.

Failure to comply with this would make him liable to disciplinary action and he may be held guilty of conduct rendering him unfit to be a member of the Institute.

(E) Joint Auditors

Two or more auditors are sometimes appointed, particularly in the case of large concerns, such as banking or insurance companies, or where the regulations of the company so require. In such cases each auditor is jointly responsible; but where the work performed by the auditors is divided by mutual agreement, it may be desirable for each auditor to avoid responsibility for work he has not performed, by a specific statement in the report as to the extent of the audit carried out by him.

(F) Branch Auditors

The audit of accounts of a branch office of a company is dealt with in Section 228. Where a company has a branch office in India, the accounts of that office shall be audited by the company's auditors or by a person qualified under Section 226. Where

the branch office is situated outside India, the accounts of that office shall be audited by the company's auditors or by a person qualified under Section 226 or by an accountant duly qualified to act as an auditor in accordance with the laws of the country in which the branch office is situated. The company may decide in general meeting to have the accounts of a branch audited otherwise than by the company's auditors in which case the meeting should appoint any qualified person as auditor of the branch or authorise the Board of directors to appoint a qualified person as auditor for the branch in consultation with the company's auditors. The branch auditor has, in respect of the audit of a branch, the same powers as the company's auditors. He should prepare a report on the accounts of the branch and forward it to the company's auditors who may deal with the same, as they consider necessary, while preparing the auditors' report. His remuneration and terms and conditions of his appointment shall be such as may be fixed by the general meeting or by the Board if so authorised by the general meeting.

When the accounts of any branch office are not audited by the company's auditor, he shall be entitled to visit the branch office if he deems it necessary and he shall have a right of access at all times to the books, accounts and vouchers maintained at the branch office. However, in case of a foreign branch of a Banking company it shall be sufficient if the auditor is allowed access to such copies or extracts from the books of accounts of the branch as have been transmitted to the principal office in India.

In exercise of the powers conferred by Section 228 (4) the Central Government have made "Companies (Branch Audit Exemption) Rules, 1961" specifying the conditions for exemption from branch audit.

(G) Special Auditors

Section 233A, Companies Act, 1956, introduces for the first time, provisions empowering Central Government to direct a special audit:

where the Central Government is of the opinion—

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

(*b*) that any company is being managed in a manner likely to cause serious injury or damage to the interests of the trade, industry or business to which it pertains; or

(*c*) that the financial position of any company is such as to endanger its solvency;—

The Central Government may, by order, specify the period or periods to be covered by special audit and specify whether it shall be conducted either by a chartered accountant (whether in practice or not) or by the company's auditors. Such auditor is referred to in the section as a 'Special auditor.' His powers and duties shall be the same as those of the statutory auditor under Section 227.

The special auditor shall make his report to the Central Government. The report shall include all matters as are required to be included in the auditor's report under Section 227, and shall further include a statement on such other matter as may be directed by the Government.

The Central Government has power to direct any person to furnish such information or additional information as the special auditor may require. The Central Government may take such action as it considers necessary on receipt of the report of the special auditor. If it does not take any action on the report within four months from its receipt, it shall send a copy or relevant extract therefrom to the company with its comments and may require the company either to circulate the same to the members or have them read before the company's next general meeting.

The expenses of and incidental to any special audit shall be determined by the Central Government and shall be borne by the company.

§ 2. The Status of the Auditor

(A) As Agent of the Members

The question as to how far the auditor is the agent of the members was discussed in *Spackman* v. *Evans* (3 H.L. 236), when Lord Chelmsford expressed the view that although auditors may be the agents of the shareholders, the latter could not be deemed to be precluded from objecting to any actions of the directors or

others merely on the grounds that the auditors were aware of such actions.

Lord Cranworth stated in the course of the same case: "The auditors may be agents of the shareholders, so far as relates to the audit of the accounts. For the purposes of the audit, the auditors will bind the shareholders."

(B) AS AN OFFICER OF THE COMPANY

The definition of the term "Officer" according to Section 2 (30) of the Act includes an auditor for the purposes of the following sections.

Sections 477 and 478 deal, respectively, with the powers of the Court, in winding up, to summon persons suspected of having property or books or papers of the company or whom the Court deems capable of giving information etc., and to order the public examination of officers guilty of fraud etc., in connection with the promotion, formation or conduct of the business of the company.

Section 539 provides—

PENALTY FOR FALSIFICATION OF BOOKS—

If with intent to defraud or deceive any person, any officer or contributory of a company which is being wound up—

(*a*) destroys, mutilates, alters, falsifies or secretes, or is privy to the destruction, mutilation, alteration, falsification or secreting of, any books, papers or securities; or

(*b*) makes, or is privy to the making of, any false or fraudulent entry in any register, book of account or document belonging to the company;

he shall be punishable with imprisonment for a term which may extend to seven years, and shall also be liable to fine.

Section 543 deals with the power of the Court, in course of winding up, to assess damages against delinquent officers:

(a) who have misapplied, or retained or become liable or accountable for, in money or property of the company; or

(b) who have been guilty of any misfeasance or breach of trust.

Sections 545 and 621 deal, respectively, with the prosecution of delinquent officers and taking cognisance by Court of offences under the Act.

Section 625 makes provisions for payment of compensation in cases of frivolous or vexatious prosecution.

Section 633 deals with power of the Court to grant relief in certain cases. If in any proceeding against an officer, for negligence, default, breach of duty, misfeasance or breach of trust, it appears to the Court that he is liable or may be liable—but that he has acted honestly and reasonably and that having regard to all the circumstances of the case, he ought fairly to be excused—the Court may relieve him either wholly or partly from his liability on such terms as it thinks fit. However, relief from civil liability as aforesaid cannot be granted in a criminal proceeding.

Where such officer apprehends that any claim will or may be made against him in respect of such matters he may apply to the Court for relief and the Court may grant relief in the manner aforesaid. In any case, before granting relief the Court should serve a notice on the Registrar or such other person as it thinks necessary, to show cause why such relief should not be granted.

§ 3. The Powers of the Auditor

I. Section 227(1), Companies Act, 1956, provides that every auditor of a company shall have a right of access at all times to the books and accounts and vouchers of the company, and shall be entitled to require from the officers of the company such information and explanations as he thinks necessary for the performance of his duties.

The auditor thus has the right of access to the company's records at all times and can, therefore, inspect them when he chooses. In practice, however, an auditor will arrange with the company a convenient date on which to commence his work, although he will usually exercise his statutory power to attend without notice for the purposes of verifying cash balances, negotiable securities etc., and should certainly do so where he suspects fraud or irregularity.

The phrase "books and accounts and vouchers" will include not only the financial books of the company, but all the books, whether statutory, statistical, or memorandum. In a similar manner the term "vouchers" will include all or any of the correspondence of the company which may in any way serve to vouch for the accuracy of the accounts.

In a case where negligence was alleged against the auditors by the directors of a company who refused them access to the books

for the purposes of the audit, the Court refused to make an order on the application of the auditors for access to the books, it being the practice of the Court, in cases affecting internal management, to direct that a meeting of members be summoned to determine their wishes in the matter (*Cuff* v. *London and County Land and Building Co.*, 1912 1 Ch. 440). The auditors are the servants of the company, appointed by the company, and if the company does not desire them to act, no Court will, by mandatory injunction, force them upon it.

II. The auditor is entitled to require from the officers of the company such information and explanations as he may think necessary for the performance of his duties as auditor. The power is very wide, and the decision as to what information and explanation is necessary is left entirely to the discretion of the auditor. If information or explanation is refused, on the ground that the directors consider it as not necessary for the performance of the duties of the auditor, the auditor can report to the members that he has not obtained all the information and explanations he has required.

III. The auditor is required to make a report to the members of the company on the accounts examined by him and on every Balance Sheet and Profit and Loss Account and on every other document declared by this Act to be part of or annexed to the Balance Sheet or Profit and Loss Account, which are laid before the company in general meeting during his tenure of office. It is the duty of the directors to prepare the accounts for presentation to the auditor, and consequently balanced books ought to be presented to the auditor. It is not the duty of the auditor to balance the books, nor should he undertake to do so, unless specially requetsed by the directors, when he will be acting in the capacity of accountant, and not as auditor. Any additional work of this nature should be specially remunerated.

Where the company's accounts are kept on a system of which the auditor does not approve he cannot *require* the directors to amend their system, but he can *advise* them to do so, and in the majority of cases the auditor's advice will be followed. Where, however, the suggestions are not carried out, he should refer the matter to the members, if in his opinion the system employed is detrimental to their interests. Should the method of accounting

be so inadequate that the auditor is unable to satisfy himself of the accuracy of the accounts he must state in his report to the members that, in his opinion, proper books of account have not been kept by the company.

IV. Section 231 provides that all notices of and other communications relating to, any general meeting of a company which any member of the company is entitled to have sent to him, shall also be forwarded to the auditor of the company.

V. Under Section 231 an auditor has the right to attend any general meeting and be heard, at any general meeting which he attends, on any part of the business which concerns him as auditor. The auditor may make any statement or explanation with regard to the accounts as he may desire. This power to make explanations at the meeting does not absolve the auditor from making a clear and unambiguous report in the usual manner under Section 227, see *infra*. Thus, the auditor cannot avoid liability for omissions or inaccuracies in the accounts merely by making a verbal explanation to such members of the company as are present at the annual general meeting.

VI. The powers of the auditor where the accounts of branch are audited by a person other than the company's auditor have been explained above.

VII. Section 221 casts a duty on the officer and other persons concerned to furnish to the company's auditor whenever he so requires any particulars or information required to be given in the Balance Sheet or Profit and Loss Account of a company or in any document required to be annexed or attached thereto.

§ 4. The Duties of the Auditor

Section 227, Companies Act, 1956, deals with powers and duties of auditors which reads as under:

(1) Every auditor of a company shall have a right of access at all times to the books and accounts and vouchers of the company, whether kept at the head office of the company or elsewhere, and shall be entitled to require from the officers of the company such information and explanations as the auditor may think necessary for the performance of his duties as auditor.

(2) The auditor shall make a report to the members of the company on the accounts examined by him, and on every balance sheet and profit and loss account and on every other document declared by this Act to be part of or annexed to the balance sheet or profit and loss

account, which are laid before the company in general meeting during his tenure of office, and the report shall state whether, in his opinion and to the best of his information and according to the explanations given to him, the said accounts give the information required by this Act in the manner so required and give a true and fair view—

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

(*ii*) in the case of the profit and loss account, of the profit or loss for its financial year.

(3) The auditor's report shall also state—

(*a*) whether he has obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purposes of his audit;

(*b*) 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;

(*bb*) whether the report on the accounts of any branch office audited under section 228 by a person other than the company's auditor has been forwarded to him as required by clause (*c*) of sub-section (3) of that section and how he has dealt with the same in preparing the auditor's report;

(*c*) whether the company's balance sheet and profit and loss account dealt with by the report are in agreement with the books of account and returns.

(4) Where any of the matters referred to in clauses (*i*) and (*ii*) of sub-section (2) or in clauses (*a*), (*b*), (*bb*) and (*c*) of sub-section (3) is answered in the negative or with a qualification, the auditor's report shall state the reason for the answer.

(5) The accounts of a company shall not be deemed as not having been, and the auditor's report shall not state that those accounts have not been, properly drawn up on the ground merely that the company has not disclosed certain matters if—

(*a*) those matters are such as the company is not required to disclose by virtue of any provisions contained in this or any other Act, and

(*b*) those provisions are specified in the balance sheet and profit and loss account of the company.

It will be observed that the auditor must report whether the Profit and Loss Account gives a true and fair view of the profit

or loss *for the financial year.* Part II of Schedule VI requires the following information to be disclosed in the Profit and Loss Account:

Clause 2—

The profit and loss account—

(*a*) shall be so made out as clearly to disclose the result of the working of the company during the period covered by the account; and

(*b*) shall disclose every material feature, including credits or receipts and debits or expenses in respect of non-recurring transactions or transactions of an exceptional nature.

Clause 3, sub-clause (xii) (b)—

Profits or losses in respect of transactions of a kind, not usually undertaken by the company or undertaken in circumstances of an exceptional or non-recurring nature, if material in amount.

Clause 3, sub-clause (xv)—

Amount, if material, by which any items shown in the profit and loss account are affected by any change in the basis of accounting.

In some business, e.g., builders, contractors and civil engineers, owing to the time which usually must elapse before final accounts, claims for increased costs, etc., can be agreed with surveyors and government departments, the profit of an accounting period may often be augmented by the addition of claims settled in respect of contracts completed in earlier years for which provision was not made at the time. If such amounts are material, they must be shown separately in the Profit and Loss Account, otherwise the auditor must qualify his report on the grounds that the profit disclosed does not represent *the profit for the financial year.* If in such cases the auditor is of the opinion that further material sums will be received in respect of completed contracts for which no provision has been made in the accounts, he must mention this matter in his report unless an adequate note covering the position has been made by the directors on the accounts.

No limitation can be placed upon the duties of the auditor under Section 227, either by the Articles of the company or by any resolution of the members.

In the case of *Newton* v. *Birmingham Small Arms Co.* (1906 2 Ch. 378) the Articles of the company provided:

(*a*) That the directors should have power to form an *internal* reserve fund which was not to be disclosed in the Balance Sheet, and which should be utilised in whatever way the directors thought fit.

(*b*) That the auditors should have access to the accounts relating to such reserve fund, and that it was their duty to see that the reserve fund was applied to the purposes of the company as specified in the special Articles, but that they should not disclose any information with regard thereto to the shareholders or otherwise.

These provisions were held to be *ultra vires* as being a limitation of the statutory duties of the auditors.

Buckley, J., said: "Any regulations which precluded the auditors from availing themselves of all the information to which under the Act they are entitled, as material for the report which under the Act they are to make as to the true and correct state of the company's affairs, are, I think, inconsistent with the Act."

The auditor is not required to *certify* the correctness of the Balance Sheet; all he is required to do is to *report* to the members whether in his opinion it is correct.

The phrase "according to the best of their information and the explanations given to them" limits the liability of the auditor in one sense, but it extends it in another. The auditor will not be held responsible if he has acted on information and explanations which he believes to be *bona-fide*, but which are as a matter of fact untrue or incorrect, provided he has exercised reasonable skill and diligence in testing the information supplied to him. On the other hand, the Balance Sheet may be correct as shown by the books of the company, but there may be information at the disposal of the auditor which would indicate that the books themselves were incorrect, and he cannot report to the members in the terms of the Act, unless he takes account of such knowledge.

In the same manner the phrase, "are in agreement with the books of account and returns," limits the liability of the auditor to some extent. He cannot be held responsible for transactions which are omitted from the books, unless by the exercise of reasonable skill and diligence he *could* have discovered them. At the same time the duty of the auditor is not confined to compar-

ing the Balance Sheet with the books to see that it agrees therewith. On this point the remarks of Lindley, L. J., *In re London & General Bank* (No. 2, 1895 2 Ch. 673) are pertinent:

"...The auditor's business is to ascertain and state the true financial position of the company at the time of the audit, and his duty is confined to that. But then comes the question: How is he to ascertain such position? The answer is: By examining the books of the company. But he does not discharge his duty by doing this without inquiry, and without taking any trouble to see that the books of the company themselves show the company's true position. He must take reasonable care to ascertain that they do. Unless he does this, his duty will be worse than a farce.... The auditor, however, is not bound to do more than exercise reasonable care and skill in making the inquiries and investigations. He is not an insurer; he does not guarantee that the books do correctly show the true position of the company's affairs.... His obligation is not so onerous as this... He must be honest—that is, he must not certify what he does not believe to be true, and he must take reasonable care and skill before he believes that what he certifies is true."

Further duties falling upon the auditor under the Companies Act, 1956, are referred to in Section 165 under which the auditor of a *public company* must certify the statutory report issued to the members, so far as it relates to the shares allotted by the company, the cash received in respect of such shares and the receipts and payments of the company.

Private companies are not required to hold a statutory meeting and, therefore, no statutory report has to be filed.

The Second Schedule, Part II requires a report by the auditor on the profits and losses, assets and liabilities and dividends paid by a company to be included in a prospectus. These matters will be more fully considered in Chapter VIII.

It is sometimes assumed that because the great bulk of the shares in a private company are held by one or two individuals, who may be directors, such persons have the right to vary the duties of the auditor, and place restrictions upon what he shall or shall not do. It need hardly be pointed out that any such attempt to limit the rights and duties of the auditor is *ultra vires*.

In *Pendlebury's Ltd.* v. *Ellis Green & Co.* (1936, 80 Acct. L. R. 29), however, it was held that where the directors of a private company are the sole shareholders, a report by the auditor made personally to the directors that he has been unable to verify to

his complete satisfaction the entries in the company's Cash Book, owing to the inadequacy of the system in force, will be sufficient to relieve the auditor from liability for not including the relevant information in his report attached to the Balance Sheet. The learned judge stated that, in considering the duty which the auditor owes to the members, some distinction must be drawn between a company with a large number of shareholders who take no part in the management of the business, and one with only two or three shareholders who happen also to be the directors, and to whom the auditor has communicated the information personally.

In case of an investigation of the affairs of a company, Section 240 casts a duty on the auditors—

(*a*) to produce to an inspector all books and papers of, or relating to, the company or, as the case may be, of or relating to the other body corporate, managing agent, secretaries and treasurers or associate, which are in their custody or power; and

(*b*) otherwise to give to the inspector all assistance in connection with the investigation which they are reasonably able to give.

In the event of resignation of office by managing agents, Section 342, provides that the Board of Directors shall require the managing agents to prepare a report on the state of affairs of the company on the date specified in the notice of resignation or a suitable subsequent date together with a balance sheet made out as on that date and a profit and loss account from the last account upto the aforesaid date.

The Board of directors shall obtain a report from the auditors of the company on such balance sheet and profit and loss account in accordance with Sections 227, 228 and 229 and place the managing agents' resignation together with the report on the state of the company's affairs, balance sheet, profit and loss account and auditors' report before the company in general meeting. The provisions of sections 230 to 233 shall apply to such auditors' report.

The duties of an auditor of banking and insurance companies have been dealt with in Chapter XIII.

§ 5. The Auditor's Report

Where the auditor is satisfied that the Balance Sheet and Profit

and Loss Account are in order, the following form of report is recommended:

To The Shareholders of
XYZ Limited.

We have audited the attached Balance Sheet of "XYZ Limited" as at .... and also the Profit and Loss Account of the Company for the year ended on that date, annexed thereto, and we report as follows:—

. . . . . .

SUBJECT TO THE ABOVE, we beg to report that:—

1. we have obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purposes of our audit;
2. in our opinion, proper books of account as required by law have been kept by the Company so far as appears from our examination of the Books *and proper returns adequate for the purposes of our audit have been received from branches not visited by us.*
3. *The accounts of .... branch office have been audited under Section 228 of the Act by ..... The report on the said accounts which has been forwarded to us has been dealt with by us, in the manner we have considered necessary, while preparing this report.*

Or

The accounts of .... branch office have not been audited as required by Section 228(1) of the Act as the said branch office is exempted from the requirements of Section 228 by virtue of Rule (3)/(4) of the Companies (Branch Audit Exemption) Rules, 1961.

4. The Balance Sheet and Profit and Loss Account dealt with by the Report are in agreement with the books of account.
5. In our opinion, and to the best of our information and according to the explanations given to us, the said Accounts read with the notes thereon, give the information required by the Companies Act, 1956, in the manner so required and give a true and fair view:—

(*a*) in the case of the Balance Sheet of the state of the affairs of the Company as at .....; and

(*b*) in the case of the Profit and Loss Account, of the profit of the Company for the year ended on that date.

The words given in Italics will only be used when appropriate.

Where any of the matters required to be stated in the auditor's report, is answered in the negative or with a qualification, the auditor's report shall state the reason for the answer.

In exercise of the powers conferred by the clause (3) of Part III of the First Schedule to the Chartered Accountants Act, 1949, the Council of the Institute of Chartered Accountants of India has directed that in all cases where a firm of Chartered Accountants is appointed as auditors of a company under Section 226 of the Companies Act, 1956, the member or partner of the firm, as the case may be, who signs the auditor's report on the accounts of the company or any other documents of the company required by the Companies Act, 1956, to be signed or authenticated by the auditor, should, at the time he affixes his signature or within a reasonable time thereafter, write to the Registrar of Companies concerned, certifying the fact of his having signed the auditor's report or other documents of the company, and for the year, to be specified by him in the letter.

If the accounts on which the auditor is reporting are not self-contained because material information is given in the directors' report or in other documents annexed to the accounts, reference to the specific documents which must be read as part of the accounts must be made by the auditor in his report, in terms which identify clearly the source to which the reference is made.

In this context, the provisions of Sections 211(6), 216 and 222 which should be noted, are given hereunder:

Section 211 (6):

For the purposes of this section, except where the context otherwise requires, any reference to a balance sheet or profit and loss account shall include any notes thereon or documents annexed thereto, giving information required by this Act, and allowed by this Act to be given in the form of such notes or documents.

Section 216:

The profit and loss account shall be annexed to the balance sheet and the auditors' report (including the auditors' separate, special or supplementary report, if any) shall be attached thereto.

Section 222:

Reference in this Act to documents annexed or required to be annexed to a company's accounts or any of them shall not include the Board's report, the auditors' report or any document attached or required to be attached to those accounts:

Provided that any information which is required by this Act to be given in the accounts, and is allowed by it to be given in a statement annexed to the accounts, may be given in the Board's report instead of in the accounts; and if any such information is so given, the report shall be annexed to the accounts and this Act shall apply in relation thereto accordingly, except that the auditors shall report thereon only in so far as it gives the said information.

Insurance or Banking companies or any company engaged in the generation or supply of electricity or any other class of companies for which a form of Banlance Sheet and Profit and Loss Account have been specified in or under the Act governing such class of companies, are exempted from the provisions of Sections 211(1) and (2).

When the auditor is reporting upon the accounts of such companies, he should state in his report that the Balance Sheet and Profit and Loss Account give a true and fair view "subject to the non-disclosure of any matters (to be indicated in the report) which by virtue of Section 211 are not required to be disclosed."

Where the auditor is of opinion that the Balance Sheet does not give a true and fair view of the state of the company's affairs, or, that the Profit and Loss Account does not give a true and fair view of the profit or loss for the year, he must qualify his report accordingly. The most common reasons for the qualification of the report are where the auditor has been unable to verify to his satisfaction the existence or values of certain assets; where, in his opinion, there has not been sufficient provision for depreciation, or where he is not satisfied that adequate provision has been made for certain liabilities.

It sometimes happens that the auditor does not agree with the

treatment of certain items in the Balance Sheet presented to him for audit, and the directors do not see their way to make such alterations as the auditor may suggest. In such a case the auditor must qualify his report.

The following is an illustration of a qualification in an auditor's report:—

I have not inspected the title deeds to Freehold and Leasehold properties, all of which are registered or held abroad. The profit disclosed for the year includes the sum of Rs. 50,000 received in settlement of claims in respect of work completed in previous years. Subject to the foregoing, in my opinion. . . .

Strong pressure is sometimes put upon the auditor to induce him to refrain from making certain comments in his report on the ground that the fact of his doing so will be detrimental to the interests of the members, and he is sometimes asked whether he cannot indicate in more or less general terms the point at issue without specifically stating the facts. The auditor who allows himself to be persuaded to do this runs the very serious risk of being held to have failed in discharging his duty to the members.

Lindley, L. J., said, *In re London & General Bank* (No. 2 1895 2 Ch. 673):

"A person whose duty it is to convey information to others does not discharge that duty by simply giving them so much information as is calculated to induce them or some of them to ask for more. Information and means of information are by no means equivalent terms. . . . An auditor who gives shareholders the means of information instead of information in respect of a company's financial position, does so at his peril, and runs the very serious risk of being held judicially to have failed to discharge his duty."

According to Section 217(3) the Board of directors are bound to give the fullest information and explanations in the Board report on every reservation, qualification or adverse remark contained in the auditors' report.

§ 6. The Publication of the Balance Sheet and Auditor's Report

Sections 215, 216 and 229, Companies Act, 1956, provide—

215. (1) Save as provided by sub-section (2), every balance sheet and every profit and loss account of a company shall be signed on behalf of the Board of directors—

(*i*) in the case of a banking company, by the persons specified in clause (*a*) or clause (*b*), as the case may be, of sub-section (2) of section 29 of the Banking Companies Act, 1949;

(*ii*) in the case of any other company, by its managing agent, secretaries and treasurers, manager or secretary, if any, and by not less than two directors of the company one of whom shall be a managing director where there is one.

(2) In the case of a company not being a banking company, when only one of its directors is for the time being in India, the balance sheet and the profit and loss account shall be signed by such director; but in such a case there shall be attached to the balance sheet and the profit and loss account a statement signed by him explaining the reason for non-compliance with the provisions of sub-section (1).

(3) The balance sheet and the profit and loss account shall be approved by the Board of directors before they are signed on behalf of the Board in accordance with the provisions of this section and before they are submitted to the auditors for their report thereon.

216. The profit and loss account shall be annexed to the balance sheet and the auditors' report (including the auditors' separate, special or supplementary report, if any) shall be attached thereto.

229. Only the person appointed as auditor of the company, or where a firm is so appointed in pursuance of the proviso to sub-section (1) of section 226, only a partner in the firm practising in India, may sign the auditor's report, or sign or authenticate any other document of the company required by law to be signed or authenticated by the auditor

It is important to observe that the auditor's report must be *attached* to the Balance Sheet. The auditor's report must be read before the company in general meeting and shall be open to inspection by any member of the company (Section 230).

Although it is considered that it is not the duty of the auditor to see that the Balance Sheet is signed by the required number of directors, it is customary for the auditor to obtain the directors' signature before attaching and signing his report.

The rights of members and others to receive copies of the Balance Sheets, etc., are as follows:

A copy of every balance sheet (including the profit and loss account, the auditors' report and every other document required by law to be annexed or attached as the case may be to the balance sheet) which is to be laid before the company in general meeting shall, not less than twenty one days before the meeting, be sent to:

(*i*) every member of the company; and

(*ii*) every debenture holder and to every trustee for debenture holders

Whether or not they are entitled to have notices of general meetings of the company sent to them. (Section 219).

The above provisions do not apply, in the case of a company not having a share capital, to members and debenture holders who are not entitled to receive notices of general meetings.

There is no longer any distinction for this purpose between public and private companies or between the holders of ordinary and preference shares.

In certain specified cases the aforesaid documents are not required to be sent.

In re Allen Craig & Co. (London) Ltd. (1934, 50 T.L.R. 301), it was held that the duty of the auditors, after having affixed their signatures to the report annexed to a Balance Sheet, is confined to forwarding that report to the secretary of the company leaving the secretary or the directors to convene the general meeting and send the Balance Sheet and report to the members entitled to receive it. It is no part of the duty of the auditors to send a copy of their report to each member individually.

If any auditors' report is made, or any document of the company is signed or authenticated otherwise than in coformity with the requirements of Section 227 and 229, the auditor concerned, and the person, if any, other than the auditor who signs the report or signs or authenticates the document, shall, if the default is wilful, be punishable with fine which may extend to one thousand rupees. (Section 233).

§ 7. The Auditor's Lien.

It is considered that an accountant has a particular lien on account books for charges incurred in the writing up of such books (*Re Hill Ex parte Southall* (1848) 17 L.J.R. (Bankruptcy 21; *Burleigh* v. *Ingram Clarke, Ltd.*, 1901, 27, Acct. L.R. 65).

In *re Arthur Francis, Ltd.* (1911, 44, Acct. L.R. 61), a lien was claimed on books and documents in the possession of accountants on the ground that they had worked upon them and had not been paid either their audit fees or accountancy charges. Swinfen Eady, J., made an order that the books should be produced to the liquidators of the company without prejudice to the lien, if any, of the respondents.

In view of the fact that Section 209, Companies Act, 1956, requires that the books of account of a registered company be kept at the registered office of the company, or at such other place in India as the directors think fit, and be at all times open to the inspection of the directors, there arises a question as to whether an accountant could exercise a lien over such books. In the opinion of counsel, obtained by the Institute of Chartered Accountants in England and Wales, however, where books of account are entrusted to an accountant by the authority of the directors there is no statutory provision which deprives the accountant of his lien over such books. In counsel's opinion an accountant claiming such a lien would have to give reasonable facilities to the directors to inspect the books. Counsel has also advised that in his opinion the accountant's lien is not affected by the appointment of a receiver for debenture holders or a liquidator.

In Chantrey Martin & Co. v. *Martin* (The Times, 15th July 1953) it was held that working papers prepared by an accountant for the purpose of producing a Balance Sheet on behalf of a client for audit purposes belonged to the accountant and not to the client. The Court held on the other hand that correspondence between an accountant and the Inland Revenue concerning a client's taxation liabilities belonged to the client.

Extracts from a statement published in 1953 by the Council of the Institute of Chartered Accountants in England and Wales on the subject of the ownership of records are given hereunder. This statement embodied the opinion given to the Institute by counsel, and emphasised that such opinion applies whether the accountant is acting as an accountant or as auditor (whether under a private arrangement or under the U.K. Companies Act, 1948) or as receiver, but is, of course, subject to any special contract made between the accountant and his client or to any special facts or circumstances in a particular case.

Working papers

(1) An accountant's working papers are his own property and he is entitled to retain them. His right to retain his working papers is not altered by the state of his client's records. The expression "working papers" is used here to mean any document that the accountant or his staff may prepare in order to help him carry out the work which he is engaged to do; for example, draft profit and loss accounts and draft

balance sheets, schedules prepared from incomplete records in order to enable such draft account to be prepared, memoranda and draft reports. These documents are clearly prepared for the accountant's own purposes and a client can have no claim to them.

(2) The above opinion is in accordance with the decision of the Court of Appeal in *Chantrey Martin & Co.*, v. *Martin* ([1953] 3 W.L.R. 459), where the Court held that the following documents were the property of the firm of accountants who acted as auditors of a company: working papers and schedules relating to the audit, draft accounts of the company, the accountants' office copy of the final typed accounts of the company, notes and calculations relating to these draft accounts made by a partner of the firm of accountants, and the draft tax computation prepared by an employee of the firm of accountants.

Correspondence with clients

(3) Letters received by the accountant from his client are the accountant's property and may be retained by him. So may the accountant's copies of his letters to his client. Clearly, when the accountant writes to his client he is not writing on his client's behalf or anyone's behalf but his own. Equally clearly, the accountant's copies of such letters are made solely for his own purposes. (*In re Wheatcroft* [6 *Ch. D.* 97]).

Communications with third parties

(4) In *Chantrey Martin & Co.* v. *Martin* the Court of Appeal held that correspondence between the accountants and the Inland Revenue in regard to the company's accounts and tax computations thereon (both the copies of letters sent and the originals of letters received) were the property of the client. This decision was on the basis that the accountants had been acting as agents for the client for the purpose of settling with the Inland Revenue the client's tax liability; and accordingly the Court followed the principle expressed by Lord Justice Mackinnon in *Leicestershire County Council* v. *Michael Faraday & Partners Ltd.* ([1941] 2 K.B. 216) that if an agent brings into existence certain documents whilst in the employment of his principal, they are the principal's documents and the principal can claim that the agent should hand them over.

(5) Having regard to the basis on which the Court of Appeal reached its decision regarding correspondence with the Inland Revenue, it is considered that the Courts would hold that communications with third parties and copies of communications by the accountant to third parties are the property of the accountant where the relationship is that of client and professional man and not, as in the case of communications with the Inland Revenue, that of principal and agent. It is considered, for example, that certificates of bank balances, certificates of the custody of securities, statements confirming or otherwise the balance of an account between a third party and the client, and other documents which the accountants have obtained for their own use in carrying out their duties in a profes-

sional capacity would be held to be the property of the accountants, notwithstanding that they have been brought into existence in connection with work done for the client.

Compliance with clients' requests

(6) Where there is any doubt as to the legal ownership of communications with third parties, it would generally be wise for the accountant, whilst keeping copies for his own protection, to supply the client with any documents the client may require (unless the accountant desires the doubtful distinction of giving his name to a leading case).

CHAPTER VIII

THE AUDIT OF A LIMITED COMPANY

§ 1. Considerations on Appointment as Auditor

The general considerations on the commencement of a new audit have been dealt with in Chapter I, § 6(B), and the importance of obtaining a list of the books in use and a statement of the system of internal check (if any) in operation has been emphasised. In the case of a limited company, there are further points which the auditor should consider at this stage.

(A) The Appointment of the Auditor

If the company is a new one, the directors will probably have exercised their power to appoint the auditor prior to the first annual general meeting, and if the auditor is so appointed, he should obtain from the secretary of the company a copy of the directors' minute recording his appointment. If appointed by the company in general meeting, in succession to a previous auditor, he should obtain a copy of the resolution, and ascertain that due notice of his intended nomination was given to the company, in the first place, and subsequently to the members and the retiring auditor in accordance with the provisions of Section 225, since if this has not been done his appointment will be invalid.

It has already been pointed out in § 1, to Chapter VII that before accepting an appointment as an auditor, a chartered accountant should comply with clauses (8) and (9) of the First Schedule to the Chartered Accountants Act, 1949. Similarly a Restricted State Auditor should comply with clauses (i) and (j) of the Appendix to the Restricted State Auditors' Certificates (Part B States) Rules, 1956.

In the case of a casual vacancy in the office of auditor, occasioned otherwise than by resignation, the directors have power to appoint a new auditor, and the auditor so appointed should obtain a copy of the directors' minute appointing him. In case of a casual vacancy caused by resignation of an auditor, the

vacancy can be filled only by the company in general meeting and the auditor should obtain a copy of the resolution in regard to such appointment.

(B) The Remuneration of the Auditor

The amount of the auditor's fee is generally based on the time which the audit is estimated to occupy, regard being had to the responsibility involved. The auditor is sometimes asked to quote the fee he requires to perform the audit, but it is often very difficult to do this with any degree of accuracy, and where the auditor is appointed by the directors before the first annual general meeting, it is usually arranged that his remuneration will be agreed with the directors after the audit is completed.

In suceeding years the remuneration is voted either in advance or retrospectively by the company in general meeting, whilst in some cases a resolution is passed authorising the directors to agree the remuneration with the auditor.

As has already been stated, the amounts paid to the auditors, whether as fees, or otherwise for services rendered (a) as auditor and (b) in any other capacity, must be shown separately in the Profit and Loss Account.

In cases where the books of the company are not balanced prior to the audit, or where draft accounts are not prepared by the company's officials and presented to the auditor, he should make it clear to the directors that it is no part of his duty to perform work of this nature, and if it is desired that he should do this, it will be in his capacity as accountant. A separate fee should be arranged for additional work of this kind.

(C) Inspection of Books and Documents

In addition to obtaining a list of all the books in use and inspecting these, the auditor should examine the following documents:

(1) *The Memorandum and Articles of Association*

The auditor should peruse the Memonrandum, and particularly the objects clauses, since occasionally the question may arise as to whether certain transactions are *intra vires* the company. If transactions have been entered into which are not within the scope of

the company's objects clause, the auditor should draw attention to the facts in his report to the members. Owing to the comprehensive nature of most objects clauses, however, this contingency rarely arises.

The Articles of Association call for careful scrutiny by the auditor upon his appointment, and special attention should be paid to the following points:

(*a*) The regulations as to the issue of capital, payment of underwriting commission, etc.
(*b*) Making calls, interest on calls in arrear, and on calls paid in advance.
(*c*) Forfeiture and lien.
(*d*) Director: their number, remuneration, qualification, disqualification and removal.
(*e*) Appointment and powers of managing agents, secretaries and treasurers, managing directors or managers.
(*f*) Proceedings and powers of the Board.
(*g*) Dividends and reserves.
(*h*) Extent of borrowing powers.
(*i*) Rights of members *inter se*.
(*j*) Accounts and audit.

Any Special Resolutions passed subsequently which alter any provision of the Articles should also be carefully noted.

(2) *The Prospectus*

Where a prospectus has been issued, the auditor should examine this, with particular reference to the following points:

(*a*) The amount of capital proposed to be issued, the different classes of shares to which it relates, and the rights of members *inter se*.
(*b*) The amounts payable on application and allotment and the dates fixed for future calls, and the amounts thereof, if any.
(*c*) Particulars of any contract or arrangement whereby any option or preferential right is given to any person who subscribed for shares or debentures of the company.
(*d*) Particulars of any contract entered into with the vendors for the purchase of any property, and the amount payable in

cash, shares or debentures in respect of such purchase consideration. The amount, if any, payable for goodwill must be specified separately.

(*e*) The amount payable for underwriting commission on shares or debentures. The rate of commission in respect of shares must not exceed 5 per cent. and in case of debentures 2½ per cent. of the issue price, or the amount or rate authorised by the Articles, whichever is less.

(*f*) The amount, or estimated amount, of the preliminary expenses and the persons by whom any of those expenses have been paid or are payable.

(*g*) The amount, or estimated amount, of the expenses of the issue and the persons by whom any of these expenses have been paid or are payable.

(*h*) Particulars of any material contracts entered into within two years of the date on which the prospectus is issued.

(*i*) The amount specified as the minimum subscription.

(3) *Contracts*

The auditor should examine all contracts with vendors or other persons relating to the purchase of property, payment of commission, or preliminary expenses.

(4) *Balance Sheet, Accounts and Reports*

When he has been appointed in place of a retiring auditor, the new auditor should examine the last Balance Sheet and Accounts, as these will contain the opening entries for the period under review. The late auditor's report should also be examined, as this may contain material information of which it is important the new auditor should be aware.

The last report of the directors to the members should be seen, as this will contain the recommendations of the directors in respect of the appropriation of the previous year's profits. The members' minute book should be examined, in order to ascertain whether such recommendations have been carried out.

It is the usual practice for the auditor to make a record of the information he has obtained with regard to the books, documents and other matters set out above. These constitute what are known as permanent audit notes, which are kept separate from the notes

relating to the annual audits, and obviate constant reference to the documents themselves. It is of the greatest importance that these notes should be kept up-to-date.

(5) *Certificate of Incorporation and Commencement of Business*

The auditor should examine the certificate of incorporation to ascertain the date when the company is formed and in the case of a public company the certificate to commence business.

A private company is entitled to commence business and exercise borrowing powers immediately after incorporation. But a public company is entitled to do so only after obtaining a certificate of commencement of business under Section 149.

Where a company having a share capital has issued a prospectus, the company shall not commence any business or exercise any borrowing powers unless the following conditions are fulfilled:

(1) Shares issued for cash should have been allotted to an amount equal to minimum subscription.
(2) Every director must have paid the same proportion of application and allotment money as is payable on the shares offered for public subscription.
(3) No money is repayable on any shares or debentures by reason of failure to obtain permission for the shares or debentures to be dealt in on any recognized stock exchange.
(4) A duly verified declaration by one of the directors or the secretary should be filed with the Registrar in the prescribed form declaring that the aforesaid requirements of Section 149 have been complied with.

Where a company has not issued a prospectus, it shall not commence any business or exercise any borrowing powers unless there has been filed with the Registrar a statement in lieu of prospectus and conditions similar to Nos. 2 and 4 mentioned in the preceding paragraphs have been fulfilled.

On filing of a duly verified declaration as aforesaid the Registrar shall certify that the company is entitled to commence business and that certificate shall be conclusive evidence that the company is entitled to commence business.

Under Section 149(4) any contract made by a company before

it is entitled to commence business shall be regarded as provisional and not binding until that date. The said contracts become binding immediately the company is entitled to commence business.

(D) CLASSES OF COMPANIES

The provisions of the Companies Act which are applicable to a company will depend upon the class of a company. The auditor must, therefore, ascertain whether the company is a public or a private company and in this behalf he should particularly note that by virtue of Section 43A, under certain circumstances, a private company may become a public company. The relevant provisions of Section 43A are as under:

(1) Save as otherwise provided in this section, where not less than twenty-five per cent. of the paid-up share capital of a private company having a share capital, is held by one or more bodies corporate, the private company shall,—

(*a*) on and from the date on which the aforesaid percentage is first held by such body or bodies corporate, or

(*b*) where the aforesaid percentage has been first so held before the commencement of the Companies (Amendment) Act, 1960, on and from the expiry of the period of three months from the date of such commencement unless within that period the aforesaid percentage is reduced below twenty-five per cent. of the paid-up share capital of the private company,

become by virtue of this section a public company:

Provided that even after the private company has so become a public company, its articles of association may include provisions relating to the matters specified in clause (*iii*) of sub-section (1) of section 3 and the number of its members may be, or may at any time be reduced, below seven:

Provided further that in computing the aforesaid percentage, account shall not be taken of any share in the private company held by a banking company, if, but only if, the following conditions are satisfied in respect of such share, namely:—

(*a*) that the share—

(*i*) forms part of the subject-matter of a trust,

(*ii*) has not been set apart for the benefit of any body corporate, and

(*iii*) is held by the banking company either as a trustee of that trust or in its own name on behalf of a trustee of that tru- , or

(*b*) that the share—

(*i*) forms part of the estate of a deceased person,

(*ii*) has not been bequeathed by the deceased person by his will to any body corporate, and

(*iii*) is held by the banking company either as an executor or administrator of the deceased person or in its own name on behalf of an executor or administrator of the deceased person;

and the Registrar may, for the purpose of satisfying himself that any share is held in the private company by a banking company as aforesaid, call for at any time from the banking company such books and papers as he considers necessary.

(2) Within three months from the date on which a private company becomes a public company by virtue of this section, the company shall inform the Registrar that it has become a public company as aforesaid, and thereupon the Registrar shall delete the word "Private" before the word "Limited" in the name of the company upon the register and shall also make the necessary alterations in the certificate of incorporation issued to the company and in its memorandum of association.

(3) Sub-section (3) of section 23 shall apply to a change of name under sub-section (2) as it applies to a change of name under setion 21.

(4) A private company which has become a public company by virtue of this section shall continue to be a public company until it has, with the approval of the Central Government and in accordance with the provisions of this Act, again become a private company.

(5) If a company makes default in complying with sub-section (2), the company and every officer of the company who is in default, shall be punishable with fine which may extend to five hundred rupees for every day during which the default continues.

(6) Nothing in this section shall apply—

(*a*) to a private company of which the entire paid-up share capital is held by another single private company or by one or more bodies corporate incorporated outside India; or

(*b*) to any other private company if, but only if, each of the following conditions is satisfied, namely:—

(*i*) that the body corporate or each of the bodies corporate holding shares in the private company is itself a private company (hereinafter in this section referred to as a shareholding company),

(*ii*) that no body corporate is the holder of any shares in any such shareholding company,

(*iii*) that the total number of shareholders of the shareholding company, or as the case may be of all the shareholding companies together with the individual shareholders [not including the persons referred to in sub-clause (*b*) of clause (*iii*) of sub-section (1) of section 3], if any, of the private company, does not exceed fifty.

The auditor should also ascertain whether the company is a subsidiary or a holding company of another company.

§ 2. Share Capital

(A) The Various Classes of Share Capital

Sections 85 to 90 make provisions in respect of various kinds of capital of a company. These sections do not apply to a private company unless it is a subsidiary of a public company. In case of shares issued before the commencement of the Act, the said sections do not affect the rights attached to the shares as to dividend, capital or otherwise. In interpreting the said provisions it is necessary to distinguish between the shares issued before the commencement of the Companies Act, 1956, and those issued thereafter.

The share capital of a company, limited by shares, formed after the commencement of the Act, or issued after such commencement, shall be of two kinds only, viz.—

(a) Equity share capital,
(b) Preference share capital (Section 86).

Section 85 which defines preference share capital and equity share capital is as under:

(1) "Preference share capital" means, with reference to any company limited by shares, whether formed before or after the commencement of this Act, that part of the share capital of the company which fulfils both the following requirements, namely:

(*a*) that as respects dividends, it carries or will carry a preferential right to be paid a fixed amount or an amount calculated at a fixed rate, which may be either free of or subject to income-tax; and

(*b*) that as respects capital, it carries or will carry, on a winding up or repayment of capital, a preferential right to be repaid the amount of the capital paid up or deemed to have been paid up, whether or not there is a preferential right to the payment of either or both of the following amounts, namely:

(*i*) any money remaining unpaid, in respect of the amounts specified in clause (*a*), up to the date of the winding up or repayment of capital; and

(*ii*) any fixed premium or premium on any fixed scale, specified in the memorandum or articles of the company.

Explanation.—Capital shall be deemed to be preference capital, notwithstanding that it is entitled to either or both of the following rights, namely:

(*i*) that, as respects dividends, in addition to the preferential right to the amount specified in clause (*a*), it has a right to participate, whether fully or to a limited extent, with capital not entitled to the preferential right aforesaid;

(*ii*) that, as respects capital, in addition to the preferential right to the repayment, on a winding up, of the amounts specified in clause (*b*), it has a right to participate, whether fully or to a limited extent, with capital not entitled to that preferential right in any surplus which may remain after the entire capital has been repaid.

(2) "Equity share capital" means, with reference to any such company, all share capital which is not preference share capital.

(3) The expressions "preference share" and "equity share" shall be construed accordingly.

In view of these provisions, the preference share capital must be preferential both as to dividends and as to repayment of capital. In addition, it may or may not have:

(i) a right to participate further in the profits;
(ii) a right to arrears of dividends;
(iii) a right to premium;
(iv) a right to participate in the surplus in the event of winding up.

Section 88 provides:

No company formed after the commencement of this Act, or issuing any share capital after such commencement, shall issue any shares (not being preference shares) which carry voting rights or rights in the company as to dividend, capital or otherwise which are disproportionate to the rights attaching to the holders of other shares (not being preference shares).

Subject to the above remarks the share capital of a company may be divided into different classes, of which the following are the most usual:

(1) *Preference Shares*

Preference shares may be either *cumulative* or *non-cumulative*. The latter only carry a right to a fixed dividend out of the profits of any year, and if there are insufficient profits in that year to pay the full amount of dividend, they have no right to have such

arrears made up out of future profits.

Cumulative preference shares entitle the holders to a fixed rate of dividend in the same way as non-cumulative preference shares, but with the additional right that any arrears of dividend shall be made up out of future profits, in priority to any dividends on other classes of shares.

The rights of preference shareholders are governed by the Memorandum and Articles *of* Association, and there are other varieties than the two enumerated above; such as, for example, participating preference shares, which have a right to further dividends after the ordinary shares have received a certain rate.

Where it is stated that preference shares are entitled to a preferential dividend at a specified rate per cent., such dividend is *prima facie* cumulative (*Webb* v. *Earle,* 1875, L.R. 20 Eq. 556; *Henry* v. *Gt. N. Rly. Co.,* 1 de G. & J. 606; *Foster* v. *Coles,* 22 T.L.R. 555). If the intention is that the preference shares should be non-cumulative, the clause defining their rights must clearly express this. A declaration that the preference dividend is to be paid out of the profits of *each year,* has been interpreted as not giving cumulative rights (*Staples* v. *Eastman Co.,* 1896 2 Ch. 303).

In the absence of specific provision, preference shares entitled to a fixed cumulative dividend are not entitled to share in any surplus profits after such dividend has been paid (*Will* v. *United Lankat Plantations Co.,* 1914, 83 L.J. Ch. 195).

The question as to whether preference shareholders are entitled to share with the ordinary shareholders in the distribution of any surplus assets after the ordinary shares have been repaid is dependent upon a true construction of the company's Articles.

The correct principle of construction is that "either with regard to dividend or with regard to the rights in a winding-up, the express gift or attachment of preferential rights to preference shares is *prima facie* a definition of the whole of their rights in that respect" (*per* Sargant, J., in *Re National Telephone Co.* (1914) 1 Ch. 755, approved by the House of Lords in *Scottish Insurance Corporation Ltd.* v. *Wilsons & Clyde Coal Co.* (1949) A.C., 462 and *Prudential Assurance Co.* v. *Chatterly-Whitfield Collieries Ltd.,* (1949), A.C. 512, over-ruling *Re William Metcalfe & Sons Ltd.* (1932), W.N. 205). In absence of provisions in the Articles,

in the event of winding-up, the *presumption* is that the preference shareholders are not entitled to any further share in the assets. Even though, on a true construction of the Articles, they may be entitled to share in a surplus, they could nevertheless not claim to participate in any part thereof which arises from profits which by the express terms of the Articles the ordinary shareholders could, prior to the liquidation, have distributed amongst themselves (*Re Bridgewater Navigation Co.* No. 2 (1891) 2 Ch. 317, approved by the House of Lords in *Scottish Insurance Corporation Ltd.* v. *Wilsons & Clyde Coal Company, supra*). There may, however, be other surplus assets in which preference shareholders could participate (*re Bridgewater Navigation Co.; Birch* v. *Cropper* (1889), 14 App. Cas. 525) but the burden of proof that they are entitled to do so is on them (*Re Isle of Thanet Electricity Supply Co. Ltd.* (1949) 2 All. E.R. 1060).

(2) *Redeemable Preference Shares.* Section 80.

A company, limited by shares, may issue preference shares which are, or at the option of the company are liable, to be redeemed subject to the following provisions:

(*a*) such issue must be authorised by the Articles;
(*b*) the redemption can only be effected out of profits available for dividends or out of the proceeds of a fresh issue made for the specific purpose;
(*c*) the shares cannot be redeemed unless they are fully paid;
(*d*) when the shares are redeemed out of divisible profits, a sum equal to the nominal value of the shares redeemed must be transferred to a "Capital Redemption Reserve Account". Provisions of the Act relating to the reduction of share capital of a company shall apply to such Capital Redemption Reserve Account as if it were paid-up share capital of the company;
(*e*) any premium payable on redemption must be provided out of profits, or out of any share premium account before the shares are redeemed.
(*f*) the Capital Redemption Reserve Account may be applied in paying up unissued shares of the company to be issued as *fully* paid bonus shares to the members.

Where shares are redeemed out of the proceeds of an issue made for the specific purpose, the company shall have power to issue shares up to the nominal amount of the shares redeemed or to be redeemed as if those shares had never been issued; and no *additional* fee will be payable on the new issue, if the redemption is effected within one month after such new issue.

The redemption of preference shares is not to be taken as reducing the amount of the company's authorised capital.

(3) *Ordinary Shares*

Ordinary shares are those taking the surplus profits remaining after satisfaction of prior interests (if any).

These may be divided between preferred and deferred ordinary shares, the former having a preferential right to a fixed rate of dividend over the latter, while the latter frequently have a right to the whole, or a proportion of the surplus after the payment of dividends on other classes of shares.

(4) *Founders' or Deferred Shares*

Founders' or *deferred* shares may be issued subject to the restrictions in the Act. Such shares are usually limited in number and of small nominal value. They are generally issued, subject to the provisions of Sections 85 and 86, fully paid to the original vendors or their nominees, in consideration either of part of the purchase price or of services connected with the formation of the company. Generally, they only rank for dividend after other classes of shares have received certain rates of dividend, when they are entitled to the whole or a portion of the surplus profits. In some instances shares of this nature are termed *management shares.*

Holders of founders' shares may be inclined to call for their maximum dividend in prosperous years, with the result that the company may not transfer adequate amounts to reserve for the purpose of equalising dividends in future years, or strengthening its general financial position; but usually the directors have power to put profits to reserve before the payment of any dividend, and where this is so, they can place so much of the profits of any year, as they think fit, to reserve, even though this may have the effect of preventing the payment of any dividend on the founders' shares (*Fisher* v. *Black & White Publishing Co.*, 1901, 1 Ch. 174).

(5) *The Distinction between Stock and Shares*:
The chief differences are as follows:

(*a*) Stock must be fully paid up; whereas shares need only be partly paid up.
(*b*) Stock may be issued or transferred in fractional parts; a fraction of a share cannot be transferred.

Under Section 94, a company, can, if so authorised by the Articles, by ordinary resolution convert all or any of its fully paid up shares into stock, and reconvert that stock into fully paid up shares of any denomination.

(B) MINIMUM SUBSCRIPTION. Section 69.
The minimum amount which, in the opinion of the Board of directors or of the signatories of the Memorandum, must be raised by the issue of share capital in order to provide for the matters specified in clause 5 of Schedule II is called the minimum subscription. The matters in respect of which provisions should be made are:

(1) Purchase price of property to be defrayed in whole or in part out of the proceeds of the issue.
(2) Any preliminary expenses payable by the company and underwriting commission on shares.
(3) The repayment of any moneys borrowed by the company in respect of any of the foregoing matters.
(4) Working capital.
(5) Any other expenditure stating the nature and purpose thereof.

The minimum subscription should be reckoned *exclusively* of any amount payable otherwise than in money.

(C) ALLOTMENT OF SHARES
Section 69 provides that no allotment shall be made of any share capital of a company offered to the public for subscription unless the following conditions are fulfilled:

(1) The amount stated in the prospectus as the minimum subscription (to be reckoned exclusively of any amount payable otherwise than in money) has been subscribed.

(2) The sum payable on application in respect thereof has been received by the company.
(3) The amount payable on application on each share must not be less than five per cent. of the nominal amount of the share.
(4) All moneys received from applicants for shares must be deposited in a Scheduled bank until the certificate to commence business is obtained or they are returned in accordance with provisions of Section 69(5).

If the aforesaid conditions have not been complied with within 120 days after the first issue of the prospectus, all moneys received for shares must be refunded, without interest, within ten days and thereafter if such money is not repaid, the directors shall be jointly and severally liable to repay the same with interest at six per cent. per annum. The aforesaid conditions, except condition (3), do not apply to allotment of shares subsequent to the first allotment of shares offered for public subscription.

Where a prospectus states that an application has been made for permission for the shares or debentures to be dealt in on a recognised stock exchange, any allotment made on an application in pursuance of the prospectus shall be void if permission has not been applied for or granted within the prescribed time limit.

Where such permission has not been applied for or granted, the company must repay without interest all moneys received from applicants and if such money is not repaid within eight days of its so becoming due, the directors shall be jointly and severally liable to repay such amount with interest at the rate of five per cent. per annum from the expiry of the eighth day. All moneys received as aforesaid shall be kept in a separate bank account maintained with a Scheduled bank so long as the company remains liable to repay it as aforesaid. (Section 73).

Under Section 75 a company is required to file with the Registrar within one month a return of allotment containing the prescribed particulars.

The auditor of a company must see that the above provisions in respect of allotment of shares are complied with and he must inspect a copy of the return of allotment in the course of share capital audit.

(D) SHARES ISSUED FOR CASH

In order to vouch shares issued for cash, the following procedure will be necessary:

(1) Check the applications with the Application and Allotment Sheets.

(2) Check the shares allotted, and the amounts payable on application and allotment, from the Application and Allotment Sheets into the Share Register.
Reference should be made to the Schedule of Split and Renounced Allotment Letters, as the names of the original allottees may in many cases not be the same as those ultimately entered in the registers.

(3) Check cash received on application and allotment with the bank statement; check the special Cash Book or machine lists in detail to the Share Register, and in total to the Application and Allotment Accounts.

(4) Where application money has been returned owing to allotment not being made, vouch repayment of cash with the Application and Allotment Accounts.

(5) Examine the directors' Minute Book to see that all allotments have been made the subject of a minute, and where only the total number of shares allotted on any day is referred to in the minutes, see that the Application and Allotment Sheets have been initialled by a director up to the point referred to in the minutes.

(6) A similar procedure should be adopted to verify the proceeds of calls.

(7) See that the issue is within the limits authorised by the Memorandum and Articles of Association.

(8) See that the provisions with regard to the minimum subscription (if any) have been complied with.

(9) Vouch the journal entries relating to the issue, and check the postings.

(10) Check the balances on the Share Registers, and see that the total agrees with the total capital issued.

(11) Ascertain that the necessary sanction required, if any, for the issue of share capital has been obtained from the Controller of Capital Issues.

(12) See that the provisions of Sections 69 and 70 in regard to allotment of shares and keeping the money received from applicants deposited in a Scheduled bank are complied with.

(13) See that proper entries are made in respect of premium, if any, on shares and for the forfeiture of shares.

If it was stated in the Prospectus that application had been or would be made for permission to deal in and for quotation for the shares on any Stock Exchange, see that:

(14) All money received on application is kept in a separate banking account so long as liability to refund such money exists.

(15) Permission to deal has been granted by the Stock Exchange or, if this has been refused, that application monies have been repaid to the applicants.

(E) ISSUE OF SHARE WARRANTS TO BEARER. Sections 114-115.

A public company, limited by shares, if so authorised by Articles, may, with the previous approval of the Central Government, issue under its common seal, share warrant stating that the bearer is entitled to the shares therein specified, and may provide by coupons or otherwise for the payment of dividends on shares specified therein. Such warrants can only be issued in respect of fully-paid shares. A private company cannot take power to issue such warrants, since they are transferable to bearer, and there can be no effective restriction on transfers. On issue of a share warrant the company must strike out of its register of members the name of the member and instead should enter in the register the fact of the issue of the warrant; statement of the shares (with distinguishing numbers) specified in the warrant; and date of issue. The bearer of a share warrant is entitled to surrender the warrant and to have his name entered as a member in the Register of Members. The auditor should check the cancelling entries in the Register of Members with those in the Register of Share Warrants, and the aggregate of the balances on both should be agreed with the total of the issued share capital.

(F) SHARES ISSUED FOR CONSIDERATION OTHER THAN CASH

The issue of shares to a vendor in part payment of the purchase consideration will be vouched by reference to the contract between the company and the vendor, and the minutes recording the allotment. Such contracts must be filed with the Registrar of Companies within one month after allotment, and the auditor should ascertain whether this has been done.

Where the contract has not been reduced to writing, particulars of it must be filed, duly stamped. The effect of non-registration of a contract, or of particulars thereof in the circumstances mentioned, within the prescribed period or such extended time as may be allowed by the Court, is the liability to a penalty of Rs. 500 a day for every day during which the default continues, on every officer who is knowingly a party to the default, but the title of the allottee is not affected so long as the contract itself is valid.

Frequently shares are issued to the nominees of the vendor, either by virtue of a supplementary agreement or under a written nomination by the vendor in favour of his nominees. The issue of such shares will be vouched by reference to these documents.

Shares are sometimes issued as fully paid to persons in consideration of the payment by them of part or the whole of the preliminary expenses of the company; the issue of such shares will be vouched in the same manner as the vendor's shares.

Payment of underwriting commission, or commission on placing shares, is usually made in cash, but it is sometimes discharged by the issue of fully paid shares. The auditor's duties in connection with the vouching of payments of this nature are considered in § 8, and assuming the issue of such shares to be in order, the vouching of the issue will be carried out in the same manner as that described above.

The auditor should vouch the journal entries relating to shares issued for a consideration other than cash with the contracts and the minute book. The shares allotted should be checked into the Register of Members.

(G) SHARES ISSUED AT A PREMIUM. Section 78.

Shares may be issued (whether for cash or otherwise) at a premium and the auditor should see that the amount of the premium is placed to the credit of a Share Premium Account, which

must be shown as a separate item in the Balance Sheet under the head "Reserve & Surplus," together with details of its utilization during the year.

The provisions relating to the reduction of the share capital shall apply as if the Share Premium Account were paid up share capital of the company. Notwithstanding this provision, the company is permitted to use the balance of the Share Premium Account for the following purposes:

(*a*) In paying up unissued shares of the company to be issued to the members as *fully* paid bonus shares.
(*b*) To write off preliminary expenses.
(*c*) To write off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures.
(*d*) In providing for the premium payable on redemption of any redeemable preference shares or debentures.

The above provisions apply equally to premiums received prior to the passing of the Companies Act, 1956, in-so-far as it is still possible to identify such premiums.

(H) SHARES ISSUED AT A DISCOUNT. Section 79.

The right to make an issue of shares at a discount is rarely exercised in practice, because the mere fact that the shares are to be issued at less than par casts doubt on their true value and acts as a deterrent to the potential investor.

The conditions imposed by Section 79, Companies Act, 1956, must be complied with if shares are to be issued at a discount. These conditions are:

(1) The new issue must be of a class of shares already issued.
(2) The issue must be authorised by ordinary resolution of the company, *and sanctioned by the Court.*
(3) The resolution must specify the maximum rate of discount (not exceeding ten per cent. or such higher percentage as the Central Government may permit) at which the shares are to be issued.
(4) There must have been an interval of at least one year between the date upon which the company was entitled to commence business, and the issue of the shares.

(5) The shares must be issued within two months after the date on which the issue was sanctioned by the Court, or within such extended time as the Court may allow.
(6) Every prospectus of the issue must show particulars of the discount or so much as has not been written off at the date of the prospectus.

Every Balance Sheet subsequently issued must show the amount of discount, not written off or adjusted to date, under the head "Miscellaneous Expenditure."

Where shares have been so issued, it will be the duty of the auditor to ascertain that due effect has been given to the statutory provisions. There does not appear to be any obligation to write off the discount, but the same principles will apply to this item as to preliminary expenses, underwriting commission, etc., and it is advisable that provision be made for the elimination of the item over a short period of years.

(I) CERTIFICATES OF SHARES ETC. Section 113.

Unless the conditions of issue provide otherwise, every company, within three months of allotment and within two months after the application for registration of the transfer, must have ready for delivery the certificates of all shares, debentures and the certificates of debenture stock, allotted or transferred. The issue of share certificates is governed by the Companies (Issue of Share Certificates) Rules, 1960.

The auditor must keep this provision in mind at the time of the audit of share capital and a share transfer audit.

(J) REGISTER AND INDEX OF MEMBERS. Sections 150-151.

Under Section 150, every company is required to keep a register of its members, and enter therein the following particulars:

(*a*) Name, address and occupation of each member.
(*b*) The shares held by each member; distinguishing each share by its number and the amount paid on those shares.
(*c*) Date at which each person was entered in the register as a member.
(*d*) Date at which any person ceased to be a member.

Under Section 151, every company having more than fifty members is required to keep an index of members unless the register of members is so maintained as to constitute an index of members.

It will occasionally be found that a Register of Transfers is kept, recording particulars of all transfers registered by the company, but usually this book is dispensed with, all postings being made direct from the transfers to the Register of Members, thus avoiding duplication.

As already stated, on the occasion of any issue of share capital, the auditor must check the entries relating thereto into the Register of Members, since it is his duty to report upon the Balance Sheet of the company, for which purpose he must ascertain that the issued capital as stated therein is correct. Once this has been done, however, it is immaterial to the auditor whether the capital is held by any particular individual member and he need not, therefore, check share transfers in detail. He should, however, check the balances on the Register of Members on the occasion of each audit, in order to see that the total agrees with the issued capital as shown in the Balance Sheet.

The majority of companies charge a fee for the registration of a transfer and these receipts must be vouched by the auditor, either by reference to the Transfer Register, the counterfoils of transfer receipts, or by counting the number of transfer deeds.

(K) Share Transfer Audit

It does not form part of the auditor's duties in the ordinary course to check the share transactions in detail, but he is frequently employed by the directors to perform this work at a special fee. Such an audit is termed a Share Transfer Audit, and its object is the prevention of clerical errors, and the improper issue of duplicate share certificates or certified transfers, whether fraudulently or otherwise. The necessity for such an audit has often been emphasised, particularly where the duties of registrar for groups of companies are carried out by a separate company under the control of the dominant directors of the groups.

Section 108 provides that a company shall not register a transfer of shares, unless a proper instrument of transfer duly stamped and executed by or on behalf of the transferor and by or on be-

half of the transferee and specifying the name, address and occupation, if any, of the transferee, has been delivered to the company along with the certificate relating to the shares or if no such certificate is in existence, along with the letter of allotment of the shares.

Section 110 requires that where the transfer relates to partly paid up shares, the transfer shall not be registered, unless the company gives notice of the application to the transferee and the transferee makes no objection to the transfer within two weeks from the receipt of the notice.

The auditor must satisfy himself that all transferors have been notified of the lodgment of transfers, and enquire as to whether any objections have been received. It must be seen that the transfers are duly executed and stamped. The distinctive numbers of the shares, if any, should be checked with the transferors' accounts in the Register of Members and with the certificate lodged with the transfer, which should be cancelled. Where part of the holding comprised in a certificate is transferred, it is the usual practice to issue a balance certificate, when it should be seen that the number of shares thereon represents the balance of shares not transferred. The entries in the accounts of the transferees will be checked in a similar manner. The new certificates and balance certificates (if any) should be checked and initialled by the auditor, and it should be seen that the counterfoils thereof are correctly entered.

On the occasion of his next visit the auditor should examine the Minute Book to ascertain whether the Board have passed all transfers previously examined by him, and, if so, he should check the postings from the transfer deeds to the Register of Members.

In case of transfer of shares by directors, managing agents, secretaries and treasurers, and managers, it should be seen that necessary changes are made in the register of their shareholdings.

(L) Forged and Blank Transfers

When a company certifies a transfer, such certificate may be taken as a representation by the company to any person acting on the faith of the certificate that there have been produced to the company such documents as *prima facie* show the transferor to have a title to the shares or debentures which are the subject of

the transfer. The certificate is not, however, a representation that the transferor has, in fact, a title. If any person acts on the faith of a false certification which has been made by the company negligently, the company will be under the same liability to such person as if the certification had been made fraudulently (Section 112).

Under Section 153, no notice of any trust, expressed, implied or constructive, may be entered on the Register of Members. But if the directors are aware that a transfer is being made in breach of trust or for the purpose of defrauding any person having equitable rights in the shares, they may become personally liable if they pass the transfer without notifying the person interested, although the company is under no liability (*Societe Generale* v. *The Tramways Union,* 1885, 14 Q.B.D. 424).

Blank transfers are frequently deposited by way of security for an advance, accompanied by a share certificate. The transfer is signed by the transferor, but the name of the transferee and the date of execution are not inserted until it is desirable to register the transfer.

If the transfer is required to be by deed, the document is not complete until the transferee's signature and date of execution are inserted, so that although it may give the transferee an equitable title, it does not give a legal title. Any alteration of the transfer renders it void as a deed unless such alteration is made with authority under seal or the transfer is redelivered by the transferor (*Ireland* v. *Hart,* 1902, 1 Ch. 522; *Societe Generale* v. *Walker,* 1885, 11 A.C. 20).

The fact that most companies note on their share certificates that no transfer will be registered without production of the certificate, does not apparently prevent a company from issuing duplicate certificates in place of those lost or defaced, and most companies take power under their Articles to issue such duplicates, a letter of indemnity from the holder usually being required. It would not be a difficult matter for the transferor who has signed a blank transfer and deposited his share certificate as security for an advance, to obtain from the company a duplicate certificate, under a misrepresentation that he had lost his original certificate, and then to execute a fresh transfer, selling the shares on the faith of the duplicate certificate so issued.

Persons lending money on the security of share certificates or certified transfers should, therefore, to prevent the possibility of loss, take immediate steps to have the transfers completed, and registered in the names of themselves or their nominees.

(M) FORFEITED SHARES

If any shares have been forfeited, the auditor should examine the minutes dealing with the matter and ascertain that due notice of forfeiture has been given to the member, in accordance with the Articles or the provisions of Table A. The Articles of a company usually lay down the procedure to be followed, and the rights and liabilities of the member whose shares have been forfeited. It is common to find that the member whose shares have been forfeited is made liable for all calls made prior to forfeiture. It is, however, not usual to treat such calls as in arrear, and only the actual cash received on account of the forfeited shares is placed to the credit of the Forfeited Shares Account. This should be shown separately in the Balance Sheet, until the shares have been re-issued, when, if the total amount received in respect of the shares is more than the nominal value thereof, the final balance standing to the credit of the Forfeited Shares Account should be transferred to Capital Reserve. It must not be taken to the credit of the Profit and Loss Account.

Shares which are forfeited for non-payment of the share money cannot be re-allotted in such a manner that the company does not get, in all, the full face value of the shares as it would amount to a contravention of Section 79. (*Biochemical and Synthetic Products Limited v. The Registrar of Companies* (1962) XXXII Comp. Cas. 654).

(N) CALLS. Sections 91 and 92

After the commencement of the Companies Act, 1956, if any calls for further share capital are made on shares, such calls shall be made on a uniform basis on all shares of the same class. For this purpose, shares of the same nominal value on which different amounts have been paid up shall not be deemed to be of the same class. The auditor must examine the provisions in the Articles of Association in regard to calls.

Where the calls are in arrears it should be seen that the interest

at the rate prescribed in the Articles is charged and the information required by Schedule VI is disclosed in the Balance Sheet.

The company may, if so authorised by its Articles, accept money from shareholders in advance of calls. Under Table "A" Article 18, power is given to pay interest at a rate not exceeding six per cent. on amounts so advanced, and such interest is a charge against the profits, but can be paid out of capital. Calls paid in advance do not strictly form part of the share capital, and should be shown separately in the Balance Sheet. In the event of winding-up, they are repayable with interest before any return is made in respect of called-up capital. (*In re Wakefield Rolling Stock Co.*, 1892, 3 Ch. 165).

(o) INTEREST PAYABLE OUT OF CAPITAL DURING CONSTRUCTION. Section 208

Where shares are issued for the purpose of raising money for the construction of works, buildings, or plant which cannot be made profitable for a lengthy period, the company may:

(*a*) pay interest on so much of that share capital as is for the time being paid-up, and
(*b*) charge such interest to capital as part of the cost of works, buildings or plant.

Subject to the following conditions and restrictions:

(1) The payment must be authorised by the Articles *or by a special resolution.*
(2) Payment shall not be made without the previous sanction of the Central Government, which is entitled to make inquiry, at the expense of the company, before sanctioning such payment.
(3) The payment shall be made only for such period as may be sanctioned by the Central Government but it must not extend beyond the close of the half year, next after the half year during which the works or buildings have been actually completed or the plant provided.
(4) The rate of interest shall in no case exceed four per cent. per annum or such other rate as the Central Government may, by notification, in the Official Gazette, direct.

(5) The payment of interest should not operate as a reduction of the amount paid up on the shares.
(6) The interest paid out of capital during construction, to the extent not written off or adjusted, should be shown in the Balance Sheet under the head "Miscellaneous Expenditure," and the rate of interest should also be stated.

Interest on debentures issued for a similar purpose can be charged to capital during the period of construction (*Hinds* v. *Buenos Ayres Grand National Tramways Co., Ltd.*, 1906, 2 Ch. 654).

(P) ALTERATION OF RIGHTS OF MEMBERS

According to Section 38, no member of a company is bound by an alteration in the Memorandum or Articles after the date on which he becomes a member, if the alteration requires him to take up shares more than those held by him at the date of alteration or in any way increases his liability to contribute to the share capital of, or otherwise to pay money to, the company unless the member agrees in writing to be bound by the alteration.

Under Section 106, the rights attached to the shares of any class may be varied, if so provided in the Memorandum or Articles or if such variation is not prohibited by the terms of issue of the shares of that class. The rights can be varied only with the consent in writing of the holders of not less than three-fourths of the issued shares of that class or with the sanction of a special resolution passed at a meeting of holders of shares of that class. In the event of variation of rights as aforesaid, the holders of not less than 10 per cent. of the issued shares of that class who have dissented may apply to the Court within 21 days of the consent being given or resolution being passed to have the variation cancelled. In such a case, the variation will not have effect unless and until it is confirmed by the Court (Section 107). The rights of members may be affected by compromise or arrangement for which provisions are made under Sections 391 to 393 or by reconstruction or amalgamation of companies which are dealt with by Sections 394 to 396.

The auditor should satisfy himself that the appropriate resolution has been duly passed, and that, where required, the approval

of the Court has been obtained. This will enable him to vouch the necessary journal entries recording the alteration. Where the scheme involves an alteration in the number of shares held by each member, or in the nominal amount of such shares, or the conversion of one class of shares into another class, the auditor should check the necessary entries in the books and also the alterations in the Registers of Members.

(Q) ALTERATION OF SHARE CAPITAL. Sections 94 and 95.

A company, if so authorised by the Articles, may alter its share capital by passing an ordinary resolution, *without* confirmation by the Court, in any of the following ways:

(1) Increase its share capital by issuing new shares;
(2) Consolidate and divide all or any of its share capital into shares of larger amount;
(3) Sub-divide any or all of its shares into shares of smaller amount, provided that the proportion of unpaid amount remains the same as before;
(4) Diminish its share capital by cancelling its unissued shares;
(5) Convert all or any of its *fully* paid shares into stock and reconvert stock into *fully* paid shares of any denomination.

The company must give notice of the alteration of its share capital to the Registrar within one month of doing so. Where a company has increased its share capital beyond its authorised capital it must file with the Registrar a notice of the increase of the capital within 15 days after the passing of the resolution authorising the increase. (Section 97).

The auditor must satisfy himself that the statutory procedure has been properly carried out, that due effect has been given thereto in the books of account, and, that the necessary alterations have been made in the Register of Members.

(R) REDUCTION OF SHARE CAPITAL

A reduction of capital must be in accordance with the provisions of Sections 100-105 of the Act. A company limited by shares or a company limited by guarantee having a share capital may:

(1) if so authorised by Articles;
(2) by special resolution; and
(3) subject to confirmation by the Court;
reduce its share capital.

The reduction may be made in *any* way and in particular the company may:

(*a*) extinguish or reduce the liability on any of its shares in respect of share capital not paid-up;
(*b*) either with or without extinguishing or reducing liability as aforesaid:

(*i*) cancel any paid-up share capital which is lost, or is unrepresented by available assets; or
(*ii*) pay off any paid-up share capital which is in excess of the wants of the company;
and accordingly alter its Memorandum of Association.

The Court may make an order directing that the company shall during a specified period add to its name, as the last words "and reduced" which shall be deemed to be part of the name of the company for such period.

The Registrar, on delivery to him of a certified copy of the Court's order and of a minute approved by the Court, is required to register and certify the registration thereof. The Registrar's certificate shall be conclusive evidence that all the requirements of the Act with respect to reduction of share capital have been complied with. The reduction of share capital takes effect on the registration of the Court's order and the Minute, and not before.

The auditor must inspect the following:

(1) the authority in the Articles;
(2) the special resolution for reducing the share capital;
(3) the Court's order;
(4) the Registrar's certificate.

The auditor must, therefore, satisfy himself that the statutory procedure has been properly carried out, that due effect has been

given thereto in the books of account, and, that the necessary alterations have been made in the Register of Members.

Where sums have been written off on reduction of capital or revaluation of assets, every Balance Sheet (after the first Balance Sheet) subsequent to the reduction or revaluation, shall, show the reduced figures with the date of reduction, in place of the original cost. Each Balance Sheet for the first five years subsequent to the date of reduction, shall show also the amount of the reduction made (Schedule VI).

(S) RESERVE CAPITAL

Section 99 provides that—

a limited company may, by special resolution, determine that any portion of its share capital which has not been already called up shall not be capable of being called up, except in the event and for the purposes of the company being wound up, and thereupon that portion of its share capital shall not be capable of being called up except in that event and for those purposes.

Uncalled capital reserved under Section 99, which cannot be called up except in the event of, and for the purposes of liquidation, cannot be made the subject of a charge (*Bartlett* v. *Mayfair Property Co.* 1898 2 Ch. 28).

(T) FURTHER ISSUE OF CAPITAL

Under Section 81, in the event of a further issue of capital, after the expiry of two years from the formation of a company or at any time after the expiry of one year from the first allotment of shares after its formation, whichever is earlier, such further shares should be offered, subject to exceptions, to the holders of the equity shares of the company, in proportion as nearly as circumstances admit, to the capital paid up on those shares at the date of the offer, in the manner provided in the section. However, a company may, by a special resolution, offer such shares to other persons. These provisions do not apply to a private company or to an issue persuant to an option attached to debentures issued or loans raised by the company under certain conditions.

(U) RESTRICTIONS ON PURCHASE OF ITS OWN SHARES. Section 77.

A company limited by shares or limited by guarantee and having a share capital is prohibited from buying its own shares, unless the consequent reduction of capital is effected.

Further, a public company or a private company which is a subsidiary of a public company cannot give, whether directly or indirectly, and whether by means of a loan, guarantee, the provision of security or otherwise, any financial assistance for the purpose of or in connection with the purchase of or subscription for any of its own shares or shares in its holding company. This restriction is subject to the following exceptions:

(1) The lending of money by a banking company in the ordinary course of its business.
(2) The provision by a company, under a scheme, for purchase of fully paid shares in the company or its holding company for the benefit of the employees including any director employed in the company.
(3) Loans to *bonafide* employees (other than directors, managing agents, secretaries and treasurers or managers).

to enable them to acquire shares in the company or its holding company up to a limit of six months' salary or wages.

(V) CONTROL OVER ISSUES OF CAPITAL

The Capital Issues (Control) Act, 1947 makes provisions for control on issue of capital. Issue of capital means issuing or creation of any securities (as defined in the Act) whether for cash or otherwise, and includes the capitalisation of profits or reserves for the purpose of converting partly paid up shares into fully paid up shares or increasing the par value of shares already issued. Except with the consent of the Central Government a company incorporated in India cannot:

(1) make an issue of capital (in or outside India);
(2) make in India any public offer of securities for sale;
(3) renew or postpone the date of maturity or repayment of any security maturing for payment in India.

Under Section 4 of the said Act, consent or recognition by the Central Government is required for circulation of:

(1) A public offer, by any person for the subscription or purchase of any securities.
(2) An offer, by a company to existing holders of the securities of that company or to existing holders of the securities of any other company specified in the offer, for the subscription or purchase of any securities of such company.
(3) A public offer, by any person for the sale of any securities issued or created under consent, by a private company or if the consent order contained a condition that the securities should be privately subscribed.

Further in the case of (1) and (2) above, a statement should be made in the offer that the necessary consent has been obtained.

Under Section 5 of the said Act, no person shall:

(*i*) Accept or give any consideration for any securities in respect of an issue of capital made or proposed to be made; or
(*ii*) Sell or purchase or otherwise transfer or accept transfer of any securities issued by a company after the 17th of May, 1943, unless consent or recognition of the Central Government has been accorded to *such* issue of capital.

The procedure for application for consent is prescribed under the Capital Issues (Application for Consent) Rules, 1954.

The Central Government have, by Capital Issues (Exemption) Order, 1949, provided for, exemptions from Capital Contral, which *inter alia* apply to issue of capital (other than by way of bonus shares) by any company up to ten lakhs of rupees within a period of twelve months.

The auditor of the company must see that the necessary consent under the said provisions has been obtained.

§ 3. The Prospectus

Where a company seeks to obtain the whole or part of its capital by public subscription, a prospectus must be issued, the preparation of which is a matter for the promoters or directors.

Where a public company does not issue a prospectus, it must file with the Registrar of Companies *a statement in lieu of prospectus* in the form and containing the particulars prescribed by the Schedule III to the Companies Act, 1956.

Under Section 60(3), the prospectus must be accompanied by the consent in writing of the person, named therein as the auditor of the company or intended company, to act in that capacity.

The Companies Act, 1956 (Schedule II, Parts II and III) requires that the prospectus shall contain the report by the auditors of the company with respect to:

(1) (*a*) profits and losses and asets and liabilities, in accordance with sub-clause (2) or (3) of this clause, as the case may require; and

(*b*) the rates of the dividends, if any, paid by the company in respect of each class of shares in the company for each of the five financial years immediately preceeding the issue of the prospectus, giving particulars of each class of shares on which such dividends have been paid and particulars of the cases in which no dividends have been paid in respect of any class of shares for any of those years;

and, if no accounts have been made up in respect of any part of the period of five years ending on a date three months before the issue of the prospectus, containing a statement of that fact.

(2) If the company has no subsidiaries, the report shall—

(*a*) so far as regards profits and losses, deal with the profits or losses of the company (distinguishing items of a non-recurring nature) for each of the five financial years immediately preceding the issue of the prospectus; and

(*b*) so far as regards assets and liabilities, deal with the assets and liabilities of the company at the last date to which the accounts of the company were made up.

(3) If the company has subsidiaries, the report shall—

(*a*) so far as regards profits and losses, deal separately with the company's profits or losses as provided by sub-

clause (2) and in addition, deal either—

(*i*) as a whole with the combined profits or losses of its subsidiaries, so far as they concern members of the company; or

(*ii*) individually with the profits or losses of each subsidiary, so far as they concern members of the company;

or, instead of dealing separately with the company's profits or losses, deal as a whole with the profits or losses of the company, and, so far as they concern members of the company, with the combined profits or losses of its subsidiaries; and

(*b*) so far as regards assets and liabilities, deal separately with the company's assets and liabilities as provided by sub-clause (2) and in addition, deal either—

(*i*) as a whole with the combined assets and liabilities of its subsidiaries, with or without the company's assets and liabilities; or

(*ii*) individually with the assets and liabilities of each subsidiary;

and shall indicate as respects the assets and liabilities of the subsidiaries, the allowance to be made for persons other than members of the company.

Where a business is to be bought directly or indirectly out of the proceeds of the issue, accountants, who must be named in the prospectus, must report upon—

(*a*) the profits or losses of the business for each of the five financial years immediately proceding the issue of the prospectus; and

(*b*) the assets and liabilities of the business at the last date to which the accounts of the business were made up, being a date not more than one hundred and twenty days before the date of the issue of the prospectus.

If the proceeds, or any part of the proceeds, of the issue of the shares or debentures are or is to be applied directly or indirectly in any manner resulting in the acquisition by the company of shares in any other body corporate, and if by reason of that ac-

quisition or anything to be done in consequence thereof or in connection therewith that body corporate will become a subsidiary of the company, the prospectus must contain a report by accountants named therein upon—

(*i*) the profits or losses of the other body corporate for each of the five financial years immediately preceding the issue of the prospectus; and
(*ii*) the assets and liabilities of the other body corporate at the last date to which its accounts were made up.

The said report shall—

(*a*) indicate how the profits or losses of the other body corporate dealt with by the report would, in respect of the shares to be acquired, have concerned members of the company and what allowance would have fallen to be made, in relation to assets and liabilities so dealt with, for holders of other shares, if the company had at all material times held the shares to be acquired; and
(*b*) where the other body corporate has subsidiaries, deal with the profits or losses and the assets and liabilities of the body corporate and its subsidiaries in the manner provided by sub-clause (3) of clause 24 of this Schedule in relation to the company and its subsidiaries.

The reports to be made by accountants named in the prospectus must be made by accountants qualified under the Act for appointment of auditors of a company and such accountants must not be officers or servants or partners or in the employment of officers or servants of the company or of the company's subsidiary or holding company or of a subsidiary of the company's holding company. The term "officer" for this purpose includes a proposed director but not an auditor. Any report required by Part II of Schedule II shall either—

(*a*) indicate by way of note any adjustments as respects the figures of any profits or losses or assets and liabilities dealt with by the report which appear to the persons making the

report necessary; or

(*b*) make those adjustments and indicate that adjustments have been made.

In some cases a company will raise capital by allotting shares or debentures to an issuing house who will then offer such shares or debentures for sale to the public. The document by which the *offer for sale* is made is for all purposes deemed to be a prospectus issued by the company.

The accountant giving the report referred to above is an expert within the meaning of Section 58, Companies Act, 1956, and the prospectus may not be issued until he has given his written consent to the issue thereof, and a statement that he has given and has not withdrawn his consent must appear in the prospectus.

Where a statement in lieu of prospectus is filed, if it is proposed to use any unissued shares or debentures of the company for the purchase of a business, the statement must contain a report by accountants named therein, in the form similar to the one required in a prospectus. (See Schedule III, Parts II and III). It is not necessary to include in a statement in lieu of prospectus a report by the auditors of the company as to the profits, etc., of that company.

It cannot be too strongly emphasised that an auditor should refrain from giving in his report for inclusion in a prospectus any estimate as to future profits, or any opinion as to the prospects of the company; his duty is confined to facts as required by statute.

§ 4. Mortgages and Charges

A *mortgage* is a transfer of an interest in property for the purposes of securing repayment of a loan with interest at a given rate. Until default is made in the terms of the deed, either as regards the payment of interest or repayment of principal, or in any other way, the mortgagor (i.e. the borrower) retains possession and use of the property, and the mortgagee (the lender) has no right to deal with it.

Under Section 125, mortgages and charges affecting the property of the company, must be registered, within 21 days after the date of creation, with the Registrar of Companies, otherwise

they will be void against the liquidator and any creditor of the company, so far as the security comprised by the charge is concerned. If so rendered void, the money secured thereby will immediately become repayable. Section 125 applies to the following charges:

(*a*) a charge for the purpose of securing any issue of debentures;
(*b*) a charge on uncalled share capital of the company;
(*c*) a charge on any immovable property, wherever situate, or any interest therein;
(*d*) a charge on any book debts of the company;
(*e*) a charge, not being a pledge, on any movable property of the company;
(*f*) a floating charge on the undertaking or any property of the company including stock-in-trade;
(*g*) a charge on calls made but not paid;
(*h*) a charge on a ship or any share in a ship;
(*i*) a charge on goodwill, on a patent or a licence under a patent, on a trade mark, or on a copyright or a licence under a copyright.

Under Section 143, every company is required to keep at its registered office a register of charges and enter therein all charges specifically affecting the property of the company and all floating charges on the undertaking or any property of the company.

The auditor should vouch the receipt of the loan and examine the register of charges in which particulars of the loan must be inserted under Section 143. In the Balance Sheet, the loan should be shown separately, on the liabilities side and the nature of the security should be specified in each case.

§ 5. Borrowing Powers

A public company cannot exercise any borrowing powers unless the provisions of Section 149 have been complied with. However, the provisions do not prevent the simultaneous offer for subscription or allotment of shares and debentures or the receipt of any money payable on applications for debentures.

The Board of directors of a company must exercise the power to issue debentures only by means of a resolution passed at a

meeting of the Board. Similarly the power to borrow moneys otherwise than on debentures must be exercised in the like manner but the Board is allowed to delegate the power, provided the resolution specifies the total amount (outstanding at any one time) upto which moneys may be borrowed by the delegate, exceptions having been made in respect of banking companies.

Under Section 293, the Board of directors of a public company or of a private company which is a subsidiary of a public company cannot, except with the consent of the company in general meeting, borrow moneys after the commencement of this Act, where the moneys to be borrowed, together with the moneys already borrowed by the company (apart from temporary loans obtained from the company's bankers in the ordinary course of business), will exceed the aggregate of the paid-up capital of the company and its free reserves, that is to say, reserves not set apart for any specific purpose. Every resolution passed by the company in relation to the exercise of the said powers shall specify the total amount upto which moneys may be borrowed by the Board of directors. The expression "temporary loans" means loans repayable on demand or within six months from the date of the loan such as short term, cash credit arrangements, the discounting of bills and the issue of other short term loans of a seasonal character, but does not include loans raised for the purpose of financing expenditure of a capital nature.

Under Section 293(5), no debt incurred by the company in excess of the limit imposed as stated above shall be valid or effectual, unless the lender proves that he advanced the loan in good faith and without knowledge that the limit imposed by that clause had been exceeded.

The Memorandum and Articles of Association should be examined to ascertain the borrowing powers of the company. Where no such provision is made, a company has no power to borrow unless such borrowing can be regarded as properly incidental to the carrying on of the business. A trading company has an implied power to borrow and give security, even without any specific powers to do so (*General Auction Estate Co.* v. *Smith*, 1891 3 Ch. 432).

§ 6. Debentures

(A) Definition of Debenture

A *debenture* is a written acknowledgment under seal of a debt due by a company, containing provisions as to payment of interest and repayment of principal. It may be either a simple or naked debenture, carrying no charge, or a debenture carrying either a fixed or floating charge on some or all of the assets of the company, either including or not, as the case may be, the uncalled capital of the company. "Debenture" includes debenture stock, bonds and any other securities of a company, whether constituting a charge on the assets of the company or not.

The requirements of Sections 125 and 143 have been explained above.

Debentures either take the form of bonds to bearer, or they may be registered in the names of the holders, transmission being by transfer. Under Section 152, every company is required to keep a register of debenture holders and enter therein the prescribed particulars and where debenture holders exceed 50 it is required to keep an index of debenture holders, unless the register is so maintained as to constitute an index.

Debenture stock may also be issued, the distinction between debentures and debenture stock being similar to that between shares and stock. Usually, debenture bonds cannot be divided and must be transferred entire; but debenture stock can be transferred in whole or in part, subject to any fractional limitations imposed at the time of issue.

On the issue of a series of debentures by a company, it is usual for two or more persons or a trustee corporation to be appointed as trustees for the debenture holders for the purpose of acting generally on their behalf.

(B) Issue of Debentures

Where a series of debentures is issued, the procedure is similar to that in the case of an issue of shares, and the work to be performed by the auditor in vouching the issue will be of the same character.

When debentures are issued for cash, the receipt of the cash must be vouched. Frequently debentures are issued to vendors of the business as fully paid in part payment of the purchase

consideration, and in such cases the auditor must examine the contracts under which the issue is made.

The auditor should examine a copy of the debentures, or the trust deed under which they are issued, in order to ascertain the terms and conditions of issue.

The auditor should ascertain that the debentures have been duly registered with the Registrar of Companies, and should examine the entries relating thereto in the Register of Charges and the Register of Debenture Holders.

Debentures may be issued at par, at a discount, or at a premium; and may be repayable at par or at a premium. Special points arise in each case, which demand consideration.

(1) *Debentures issued at a Premium*

Although the Companies Act, 1956, does not prescribe the manner in which premiums received on an issue of debentures should be dealt with, it is considered that they should be regarded as capital profits and classified in the Balance Sheet as a capital reserve. Alternatively, they may be utilised to form the nucleus of a Debenture Redemption Fund; or, if not employed in this manner, they may be used to write off fictitious assets. It is usual to charge the expenses of issuing the debentures against the premium received.

In the Balance Sheet the debentures will appear as a liability at their *nominal* value.

(2) *Debentures issued at a Discount*

Debentures can be issued at a discount subject to the provisions of Section 76(2). The discount can be regarded as a lump sum allowance to the lenders when taking up the debentures, in consideration of their accepting a lower rate of interest than would have been payable had the debentures been issued at par. The financial position of the company and the state of the money market at the date of issue are important factors in determining the price of issue.

The debentures will appear in the Balance Sheet as a liability at their *nominal* value, and the discount will be written off over a period of years, the balance remaining at any date being carried forward as a separate item in the Balance Sheet. Any sums paid

by way of commission in respect of the issued debentures, or allowed by way of discount, must be stated in the Annual Return.

As this discount is not represented by any value it is advisable that it should be written off as soon as possible. It cannot be said, however, to be incorrect to write off the discount over the term of the debentures; and in that case, when no sinking fund is formed for the purpose of repaying the debentures, and the debentures are repayable at the end of a given period, an equal amount of the discount should be written off each year. If the debentures are repayable by annual drawings, without the provision of a sinking fund, the discount should be written off in relative proportion to the amount of debentures outstanding each year, in order that the periods enjoying the use of the greater portion of the debentures may be charged with the greater portion of the discount.

Where the redemption of the debentures is provided for by annual charges against Profit and Loss Account, such charges will include provision for the discount, and, consequently, the discount can be written off against the credit balance of the Redemption Account when the debentures have been redeemed.

(3) *Debentures repayable at a Premium*

These debentures will appear in the Balance Sheet as a liability at their nominal amount, with a note of the amount at which they are repayable, any discount or premium on issue being treated in one of the ways described above.

If a sinking fund is formed to provide for repayment, this should include provision for the payment of the premium on redemption. If no sinking fund is formed, the premium should be provided for out of profits over the term of the debentures.

(4) *Debentures issued as Collateral Security for a Loan*

It is a common practice for companies to issue debentures as collateral security against a loan or overdraft from a bank or other parties. Section 121 (4) expressly refers to this procedure, and provides that such debentures shall not be deemed to have been redeemed by reason only of the account of the company having ceased to be in debit whilst the debentures remained so deposited.

The term collateral security means a security which can be

realised by the party holding it, in the event of the original loan in respect of which the security was given not being repaid at the proper time, or in any other specific cases, according to the agreement between the parties. As soon as the loan is repaid, the collateral security is automatically released.

When debentures are issued in this manner a note to this effect should be shown on the Balance Sheet. The loan against which they are issued will appear as a liability in the usual way.

(c) Redemption of Debentures

Debentures may be redeemable according to the terms of issue, at specified dates, by annual or other drawings, or at the option of the company, after due notice has been given of intention to repay.

The auditor should examine the provisions of the trust deed, or the debenture bonds, relating to the redemption, and ascertain that they are duly complied with.

Where the debentures are redeemable at the end of a given period, it is usual to find provision made in the trust deed for a sinking fund to be raised out of profits for this purpose.

The operation of such a fund entails a charge against Profit and Loss Account each year of an amount which, if invested at compound interest, will produce the required sum at the end of a given period. The investments so made are usually held in the names of the trustees for the debenture holders. When redemption takes place, the investments will be sold and the debenture holders paid off. The amounts standing to the credit of the redemption or sinking fund will then represent accumulated profit, but in place of being invested in specific assets, will be represented by the general assets of the business which had previously been subject to the charge of the debentures. The amount of such fund should therefore be transferred to reserve. It cannot, as a rule, be used for the payment of dividends, since it may not be represented by available cash; but there would be no legal objection to its being utilised in this way if the liquid funds were available, since it has been built up out of revenue.

Where debentures have been redeemed in the open market at a discount, but the full nominal amount has been provided for by the operation of a sinking fund, the profit on the redemption

can be taken to the Profit and Loss Account, as it represents an amount previously provided in excess of that actually required for redemption. It is, however, preferable to place the amount to reserve.

Where no sinking fund has been provided, any profit on redemption should be taken to reserve and not credited to the Profit and Loss Account.

In vouching the redemption of debentures, the auditor should examine the cancelled debenture bonds or stock certificates, and inspect the directors' minute authorising the redemption.

Instead of investing the redemption fund in securities, it is a common practice to effect an endowment policy with an insurance company, under which annual premiums are paid, the insurer undertaking to provide the capital sum required, at the end of a given period. Such policies will be assigned to the trustees for the debenture holders, if any, but the premiums will be paid by the company, the annual amount thereof being debited to the Profit and Loss Account and credited to the Redemption Account, while the premiums paid will be debited to the Policy Account. The only distinction between this method and that of making specific investments is that accruing interest will not be received in cash or require to be invested. Unless, however, some account is taken of accruing interest, the book value of the policy will ultimately be less than its surrender value. If it is desired to maintain the policy in the books at its surrender value, the necessary adjustments will be made through the Redemption Account.

Where debentures are redeemable by annual drawings on the principle of a sinking fund, although it is necessary to debit Profit and Loss Account and credit the Redemption Account with the amount required for the annual drawing, it will not be necessary to invest such amount, as the money represented thereby is immediately paid out in discharge of the drawn debentures. The amount standing to the credit of the Redemption Account will, as soon as the debentures have been drawn and paid off, be transferred to reserve.

Debentures may also be irredeemable or perpetual, and specific provision is made for the legality of such debentures by Section 120.

Power is granted to re-issue redeemed debentures in certain

cases by Section 121. Under this section, where either before or after the commencement of the Act, a company has redeemed any debentures previously issued, then, unless any provision to the contrary is contained in the Articles, or in any contract entered into by the company, or the company has passed a resolution, or by some other act indicates its intention that the debentures shall be cancelled, the company shall have, and shall be deemed always to have had power to re-issue the debentures, either by re-issuing the same debentures, or by issuing other debentures in their place.

Where a company has power to re-issue debentures which have been redeemed, particulars with respect to the debentures which can be so re-issued must be included in every Balance Sheet of the company issued subsequent to the redemption and up to the date of re-issue.

There is no prohibition against a company purchasing its own debentures, and where any of the company's debentures are held by a nominee or a trustee for the company, the nominal amount of the debentures and the amount at which they are stated in the books of the company should be shown in the Balance Sheet.

§ 7. Preliminary and Formation Expenses

This is the term given to the expenses incidental to the creation and flotation of a company. The following items are usually included under this heading:

(1) Stamp duties and fees on the nominal capital, and stamps on the contracts transferring the assets.
(2) The legal costs of preparing the Prospectus, Memorandum and Articles of Association and contracts, and of the registration of the company.
(3) Accountants' and valuers' fees for reports, certificates, etc.
(4) Cost of printing the Memorandum and Articles of Association, and printing, advertising, and issuing Prospectuses.
(5) Cost of preparing and printing letters of allotment, and share certificates.
(6) Cost of preparing, printing and stamping debentures and debenture trust deed (if any).
(7) Cost of the company's seal and statutory books.

These preliminary and formation expenses are sometimes borne entirely by the company, and sometimes by the promoters or the vendors, or apportioned between these parties. Care must be taken to see that the company is only charged with expenses properly payable by it, and the auditor must examine the contracts relating to these expenses, and vouch the payments made. This expenditure is of a capital nature, but as it is not represented by available assets, it is advisable that it should be written off as soon as possible out of revenue.

Where a premium is received on shares issued, it is common to find the preliminary expenses charged against such premium, and power to do so is given by Section 78.

Expenditure in connection with preliminary expenses, so far as it has not been written off to date, must be shown as a separate item in the Balance Sheet under the head "Miscellaneous Expenditure" and similarly any expenses incurred in connection with the issue of share capital or debentures must also be shown separately.

Underwriting commission and brokerage on shares or debentures must not be included under the general heading "Preliminary Expenses," but must be likewise shown separately in the Balance Sheet, until written off.

§ 8. Underwriting Commission

Underwriting commission is the amount payable to persons who undertake to subscribe for a certain number of shares, in the event of the public not taking up the whole of the shares for which they are invited to apply. An underwriting contract is therefore in the nature of a speculation. If the public subscribe for the total of the shares available, the underwriters receive their commission, and do not have to take up any shares. If the public do not subscribe for the issue in full, the underwriters have to take up the shares not subscribed for, in proportion to their contracts. It is usual for the underwriters to make formal application for the shares they underwrite, on the understanding that allotments to them will be made only to the extent to which the public do not apply.

Under Section 76, a company may pay commission to any person in consideration of—

(i) subscribing or agreeing to subscribe, or
(ii) procuring or agreeing to procure subscriptions:
whether absolutely or conditionally, for any shares in or debentures of the company, if the following conditions are fulfilled, viz.:

(*a*) the payment of the commission is authorised by the Articles;
(*b*) commission does not exceed:
  (i) in the case of shares, five per cent. of the price at which the shares issued or the amount or rate authorised by the Articles whichever is less, and:
  (ii) in the case of debentures two and a half per cent. of the price at which the debentures are issued, or the amount or rate authorised by the Articles, whichever is less.
(*c*) The amount or rate per cent. of the commission is disclosed:
  (i) in the prospectus in case of offer to the public for subscription or
  (ii) in the statement in lieu of prospectus or in a statement in the prescribed from filed with the Registrar; *and*
  (iii) in a circular or notice not being a prospectus.
(*d*) The number of shares or debentures which persons have agreed to subscribe is disclosed in the manner aforesaid.

Section 76 does not affect the powers of the company to pay such brokerage as it has heretofore been lawful for a company to pay.

This commission is usually payable in cash, but sometimes it is satisfied by the issue of fully paid shares, or partly in cash and partly in shares.

In some companies, in place of paying commission, an option is given to the underwriters to subscribe within a specified period for a certain portion of the company's unissued shares at par or at a fixed premium, and where such shares are likely to go to a high premium, this option may be of considerable value. It was held by the House of Lords (*Hilder* v. *Dexter,* 1902, A.C. 474) that such an arrangement is not an application of shares in payment of commission within the meaning of Section 53 of the English Companies Act, 1948. Where such an option has been

given, the auditor must see that a note thereof appears on the accounts or in a statement or report annexed thereto giving particulars of the period during which the option is exercisable, and the price to be paid for the shares subscribed under it (Schedule VI, Part I).

In order to vouch the payment of underwriting commission, the auditor should examine the Articles of Association, where power is given to make payments of this nature, and should ascertain that the provisions of Section 76 have been duly complied with. The underwriting contract should be seen and also the application letters signed by the underwriters. The amount or rate per cent. paid must not exceed that authorised, and where payment has been made in shares, it should be seen that the proper contracts have been filed.

Should the auditor find that the underwriter's calls or payments on allotment are in arrear, he should mention this fact in his report to the members.

The vouching of commission on placing shares is somewhat more difficult, as it is not easy for the auditor to satisfy himself that commission paid to any person is in respect of applications actually introduced by such person. No commission should be paid unless the application form on which the shares have been allotted was initialled by the party claiming the commission before being sent into the company, and the auditor should examine the application forms in respect of which such commission is payable, to ascertain whether this has been done. All commission of this nature should be referred to in the minutes, and a resolution passed by the directors for the payment thereof.

Brokerage on placing shares is an amount payable to brokers and other agents whose clients have subscribed for shares in the company, on application forms stamped with the agent's stamp.

Such a brokerage, not exceeding two and a half per cent. has been held to be *intra vires* the company (*Metropolitan Coal Consumers Association* v. *Scrimgeour,* 1895, 2 Q.B. 604), and the payment thereof is not subject to the restrictions imposed by Section 76. In order to vouch items of this nature, the auditor should examine the application letters, ascertaining that these are stamped by the agents concerned.

The total of any sums paid or allowed by way of commission

in respect of any shares, or so much thereof as has not been written off, or adjusted, must be stated separately in every Balance Sheet under the head "Miscellaneous Expenditure."

The Annual Return must disclose the total amount of the sums (if any) paid by way of commission in respect of any shares or debentures upto that date.

There is nothing in the Act to prevent the payment of such commissions out of revenue. The underwriting commission can be charged against Premium on Shares as the power to do so is given by Section 78.

§ 9. The Statutary Audit

This is a term commonly applied to the audit required to be performed by the auditor, prior to the *statutory meeting* of the company. Under Section 165, every *public* company must hold a general meeting not less than one month, nor more than six months, after the date on which the company is entitled to commence business, and such meeting is called the statutory meeting.

At least twenty-one days (unless a shorter period is agreed to by all the members, entitled to attend and vote) before the date on which this meeting is to be held, the directors must forward a report, called *statutory report,* to every member of the company. This report must be certified as correct by not less than two directors of the company (one of whom shall be a managing director, where there is one).

The statutory report must state—

(*a*) The total number of shares allotted, distinguishing shares allotted as fully or partly paid up otherwise than in cash, and stating in the case of shares partly paid up, the extent to which they are so paid up, and in either case, the consideration for which they have been allotted;

(*b*) The total amount of cash received by the company in respect of all the shares allotted, distinguished as aforesaid;

(*c*) An abstract of the receipts of the company and of the payments made thereout, up to a date within seven days of the date of the report, exhibiting under distinctive headings:

(i) the receipts of the company from shares and debentures and other sources,

(ii) the payments made thereout, and particulars concerning the balance remaining in hand, and

(iii) an account or estimate of the preliminary expenses of the company, showing separately any commission or discount paid or to be paid on the issue or sale of shares or debentures;

(*d*) The names, addresses and occupations of the directors of the company and of its auditors; and also, if there be any, of its managing agent, secretaries and treasurers, manager, and secretary; and the changes, if any, which have occurred in such names, addresses and occupations since the date of the incorporation of the company;

(*e*) The particulars of any contract which, or the modification or the proposed modification of which, is to be submitted to the meeting for its approval, together in the latter case with the particulars of the modification or proposed modification;

(*f*) The extent, if any, to which each underwriting contract, if any, has not been carried out, and the reasons therefor;

(*g*) The arrears, if any, due on calls from every director; from the managing agent, every partner of the managing agent, every firm in which the managing agent is a partner, and where the managing agent is a private company, every director thereof; from the secretaries and treasurers; where they are a firm, from every partner therein; and where they are a private company, from every director thereof; and from the manager; and

(*h*) The particulars of any commission or brokerage paid or to be paid in connection with the issue or sale of shares or debentures to any director; to the managing agent, any partner of the managing agent, any firm in which the managing agent is a partner; and where the managing agent is a private company, to any director thereof; to the secretaries and treasurers; where they are a firm, to any partner therein; and where they are a private company, to any director thereof; or to the manager.

So much of the report as relates to the shares allotted by the company, the cash received in respect of such shares and the receipts and payments of the company must be certified as correct by the auditors of the company.

The recent amendment makes it clear the auditor must certify all the receipts and payments of the company and not merely receipts and payments on capital account.

The form of statutory report prescribed under form 22 of the Companies (Central Government's) General Rules & Forms. 1956, is given below:

No. of Company — Form No. 22
Filing Fee Rs. 5.

THE COMPANIES ACT, 1956
Statutory Report.
Pursuant to Section 165.

Name of Company
Statutory Report of the Limited,
certified and filed pursuant to section 165(5).
Presented by _____

The Board of Directors submits this statutory report to the members in pursuance of section 165.

1. Shares allotted and cash received upon .....(a)

	No of shares.	Nominal value of each share.	Cash received upto (a).
(a) Allotted subject to payment thereof in cash,			
(i) Equity.			
(ii) Redeemable Preference Shares.			
(iii) Preference shares other than Redeemable Preference Shares.			
(b) Allotted as fully paid up otherwise than in cash and the consideration for which they have been allotted.			
(i) Equity.			
(ii) Redeemable Preference Shares.			

(iii) Preference shares other than Redeemable Preference Shares.

(c) Allotted as partly paid up to the extent of Rs. ———— per share, and the consideration for which they have been so allotted.
(i) Equity.
(ii) Reedemable Preference Shares.
(iii) Preference shares other than Redeemable Preference Shares.

(d) Allotted at a discount of Rs. ———— per share.
(i) Equity.
(ii) Reedemable Preference Shares.
(iii) Preference shares other than Redeemable Preference Shares.

2. Abstract of receipts and payments upto (a):—

Receipts.	Rs.	Payments.	Rs.
Shares		*Preliminary expenses.*	
Equity.		Commission on issue or sale of shares	
Redeemable Preference Shares.		Discount on issue or sale of shares	
Preference share of other than Redeemable Preference shares.			
Advance payment for shares.		Capital Expenditure.	
Debentures		.....	
Loans		Land	
Deposits		Building	
Other Sources.		Plant	
(to be specified)		Machinery	
		Other Items to be specified.	
		Balances	
		In hand	
		At Banks	
		At Post Office	
		Savings Bank	
Total		Total	

(a) The date should be a date within 7 days of the Report.

3. Preliminary expenses as estimated in the Prospectus* or Statement in lieu of Prospectus.....

	Preliminary expenses actually incurred upto aforesaid date. Rs.	Preliminary expenses estimated to be incurred after the aforesaid date. Rs.
Law charges.		
Other charges in connection with the preparation of the Memorandum and Articles of Association.		
Printing Expenses.		
Registration charges.		
Advertisement charges.		
Commission on issue or sale of shares.		
Discount on issue or sale of shares.		
(Other initial Expenses. To be specified as far as possible)		
TOTAL Rs.		

*Strike out the portion which does not apply.

4. Names, addresses and occupation of the company's Directors, auditors, Managing Agents/Secretaries and Treasurers, Manager and Secretary.

Name(s)	Address(es)	Occupation(s)	Particulars of change(s), if any, in entries in columns (1), (2) and (3) since the date of incorporation	Date of the change
1	2	3	4	5
A. *Directors*				
B. *Auditors*				
C. *Managing Agent/Secretaries and Treasurers*				
D. *Manager*				
E. *Secretary*				

These particulars must include dates of changes.

5. Particulars of any contract which is to be submitted to the statutory meeting for approval.

(If any modification or proposed modification of a contract is to be submitted for such approval, brief particulars of contract and particulars of modification or proposed modification should be given).

6. *Underwriting contracts.*

Brief description of each contract.

If contract not carried out fully, extent to which it has not been carried out and reasons thereby.

7. The arrears, if any, due on calls from Directors, Managing Agent, Secretaries and Treasurers and Manager.

NAMES *Amount due.*

Directors:

NAMES *Amount due.*

Managing Agent/Secretaries and Treasurers

Where Managing Agent is an individual name of Managing Agent.

**Partners of Managing Agent.*

**Firms in which Managing Agent is a partner.*

**Partners in firm acting as*

Managing Agent/Secretaries and Treasurer.

†*Directors of Managing Agents/Secretaries and Treasurer.*

Manager.

8. Particulars of any commission or brokerage paid or to be paid in connection with the issue or sale of shares to any director, managing agent or manger or if the managing agent is a firm, to any partner thereof, or if the managing agent is a private company, to any director thereof.

Name.

Commission or Brokerage paid or to be paid.

On Shares On Debentures

Directors:

*Where Managing Agent is a firm.

†Where Managing Agent is/Secretaries and Treasurers are a private company.

Managing Agent.
Where Managing Agent is an Individual, name of managing agent.
**Partners of Managing Agent.*

* *Firms in which Managing Agent is a partner.*

**Partners in firm acting as Managing Agent/Secretaries and Treasurers.*

† *Directors Managing Agents Secretaries and Treasurers.*

Manager.

Dated this day of 19

We hereby certify that the above report is correct.

Signatures of two or more Directors.‡

We hereby certify as correct so much of the report as relates to the shares allotted by the company and to the cash received in respect of such shares and to the receipts and payments.

Auditors

Dated this day of 19

*Where Managing Agent is a firm.
†Where Managing Agent or Secretaries and Treasurers is a private company.
‡Where there is a managing director, he shall be one of the signatories.

The work to be performed by the auditor in connection with the shares allotted and cash received in respect thereof, will follow the lines laid down for the audit of the issue of share capital in § 2 (D) and (E) of this Chapter.

The auditor must vouch all the receipts and payments and examine the contracts with the vendors; the work necessary in connection with the vouching of payments for the preliminary and formation expenses and commission on the issue of shares has already been discussed. The auditor must carry out a complete audit of the issue of share capital.

A *private* company is *not* required to hold a statutory meeting or prepare a statutory report. If a company is initially formed as a private company and subsequently converted into a public company, it will not be required to hold a statutory meeting or issue a statutory report.

§ 10. Adjustment of Accounts with Vendors

(A) Purchase of Business

Where a company acquires a business, the auditor should vouch the journal entries recording the assets acquired and liabilities taken over (if any), with the contracts between the vendors and the company. Where a prospectus has been issued, the amount payable for goodwill must be specified therein, and will be equivalent to the difference between the value of the tangible assets acquired and the amount of the consideration payable to the vendors, plus the liabilities taken over (if any).

Where the purchase consideration is less than the value of the tangible assets acquired, there will be no goodwill, but on the other hand a surplus will be shown representing a book profit. The cost of such assets to the company is only the amount paid therefor, and consequently any apparent surplus should preferably be utilised in adjusting the values of the assets acquired. Where, however, such treatment is not desired, the amount should be placed to the credit of a Capital Reserve Account, which will not be available for revenue purposes.

Where a reconstruction has taken place, and a new company has been formed to take over from the liquidator of the old company all the assets of that company, and possibly also to undertake certain of its liabilities, the old company receiving the purchase consideration either wholly or partly in shares of the new company, the auditior of the reconstructed company should examine the contract under which the assets are acquired, and ascertain that all such assets are duly brought into account. In some cases the liabilities of the old company may be wholly or partly satisfied by the issue of shares or debentures, and where this is so, the auditor should vouch the issue of such shares or debentures, and ascertain that it is in accordance with the contract

(B) Apportionment of Profit or Loss prior to Incorporation

Frequently a company takes over a business as and from a date prior to the incorporation of the company itself. In such an event any profits earned prior to the date of incorporation, to which the company may be entitled, cannot be regarded as profits available

for dividend, but are of a capital nature, since the company cannot earn profits before it comes into existence. When the vendors are not entitled to take such profits, they are usually entitled to interest on the purchase consideration from the date when the business was taken over to the date when the purchase consideration is discharged. If that is so, the interest payable to the vendors for the period from the date of taking over the business till the date of incorporation can be charged against the profits earned during that period, any interest payable in respect of any period after the date of incorporation being charged against the Profit and Loss Account. The remaining balance of profit earned prior to incorporation (if any) should either be written off the goodwill, or, if there is no goodwill, some other fixed asset, or carried forward as a capital reserve not available for revenue purposes.

If stock is not taken at the date of incorporation, and the exact profit thereto cannot consequently be ascertained, it is necessary to arrive at the approximate proportion of profits applicable to the period prior to incorporation. This may be done by apportioning the whole of the profit earned according to the time covered by the respective periods, or in proportion to the turnovers of those periods. A more accurate division of profit will, however, be obtained by apportioning *gross* profit, and the expenses which vary with turnover, between the two periods on the basis of their respective turnovers, and all other expenses on the basis of time.

The date of the division, in these cases, should be the date of incorporation, and not, in the case of a public company, the date of the certificate entitling it to commence business; since once that certificate has been issued the company's power of legally carrying on business relates back to the date of incorporation.

The auditor must take care to see that an equitable division of profit has been made between the two periods, and that the period subsequent to incorporation (the profits of which are available for dividends) has not been favoured at the expense of the prior period.

In the event of a loss in the first period it is not usual to make any apportionment in respect of the period prior to incorporation, but to carry forward the debit balance against future profits. However, there is nothing to prevent the proportion of the loss relat-

ing to the period prior to incorporation being added to the Goodwill Account as it represents, in fact, an increase in the price paid for that asset.

(c) Receipt and Payments on behalf of Vendors

In some instances the company does not acquire the book debts from the vendors, but, for the purposes of convenience, undertakes to collect them on their behalf. In such cases, the company does not, as a rule, take over the liabilities, but for similar reasons arranges to pay these liabilities out of the proceeds of the book debts. Where this is so, the assets and liabilities concerned should be brought into the books of the company for the purpose of recording what ought to be collected and paid away on behalf of the vendors, the book debts being credited to the vendors and the liabilities debited. The auditor should see that the cash received from the debtors, or the payments made to the creditors, are duly apportioned as between the company and the vendors. Any discount or bad debts relating to the vendors' book debts must be borne by the vendors.

Sometimes the company takes over the book debts, their value being guaranteed by the vendors. Any bad debts incurred relating to such debts will therefore be charged to the vendors. It is an open point whether cash discount allowed on payment of such debts within the usual term of credit can be so charged; but this will depend on the precise wording of the contract with the vendors. The auditor should take care to ascertain that all losses properly chargeable against the vendors are debited to them.

The contract should be consulted to ascertain whether there are any provisions other than those above referred to affecting the adjustment of the accounts between the vendors and the company. It is sometimes arranged that the vendors shall account for all money withdrawn from the business between the date from which the company acquires it and the date when the company takes it over, and in the same manner any sums paid into the business during that period by the vendors may be repayable to them.

CHAPTER IX

THE AUDIT OF A LIMITED COMPANY

1. Directors

(A) Appointment of Directors

The term "Director" includes any person occupying the position of director, by whatever name called. Every public company must have at least three directors and every private company must have at least two directors. Only an individual can be appointed a director of a company. A company in general meeting may, subject to the provisions of the Act and Articles, by ordinary resolution increase or reduce the number of directors; but in the case of a public company or a private company which is a subsidiary of a public company such increase requires prior approval of the Central Government, subject to exceptions.

In absence of provisions in the Articles, until the directors are duly appointed the subscribers of the Memorandum are deemed to be the directors of the company.

The directors are usually appointed by a company in general meeting subject to certain exceptions.

In case of a public company or a private company which is a subsidiary of a public company at least two-thirds of the directors should be liable to retirement by rotation. Under Section 261, in case of a public company or a private company which is a subsidiary of a public company, certain persons connected with managing agents cannot be appointed directors except by special resolution. Section 266 lays down restrictions on appointment or advertisement of a director. Subject to the provisions of the Act, the company may appoint additional directors, alternate directors or fill a casual vacancy.

After the commencement of this Act, no person can, except as provided in Section 276, hold office as director in more than *twenty* companies at the same time.

Section 280 provides that no person shall be capable of being appointed a director of a company, if at the time of appointment,

he has attained the age of sixty-five. The section also provides that any director reaching the age of sixty-five shall vacate his office at the conclusion of the annual general meeting commencing next after he attains the age of sixty-five. A person appointed as director, before the age of sixty-five, is not required to vacate his office within three years after his appointment merely on the ground of age limit. A director who was in office at the commencement of the Act, however, may continue to hold office until the third annual general meeting after the commencement of the Act if he has attained the age of sixty-five before the commencement of that meeting. The provisions of this section do not apply to a private company unless such company is a subsidiary of a public company.

Notwithstanding the above provisions, a person over sixty-five years of age may be appointed a director or may continue to act as such after reaching that age if, his appointment was made or approved by the company in general meeting and special notice was given of the resolution, the notice stating the director's age. The resolution must specifically declare that the age limit shall not apply. Any person appointed or proposed to be appointed a director of a company, who is subject to the above provisions, must give notice to the company when he attains the retiring age applicable to him under the Act or the Articles of the company. Any person failing to comply with this section will be liable to a fine not exceeding Rs. 50 a day for every day in which failure to notify continues, or in which he acts as director if his appointment has been terminated or become invalid by reason of his age.

(B) QUALIFICATIONS

It is the duty of every director who is required to hold qualifition shares by Articles, to obtain his qualification shares within two months after his appointment.

Any provision in the Articles requiring a person to hold qualification shares before his appointment or to obtain them within a shorter time than two months after his appointment, is void.

The nominal value of the qualification shares shall not exceed Rs. 5,000, or the nominal value of one share where it exceeds five thousand rupees. Every director not being a technical director or a director appointed by the Central or State Government

must, within two months, file with the Registrar a declaration specifying qualification shares held by him. These provisions do not apply to a private company unless it is a subsidiary of a public company.

A person shall not be capable of being appointed a director of a company under the circumstances mentioned in Section 274(1) and the office of a director shall become vacant in the circumstances mentioned in Section 283. Subject to the provisions of Section 284, he can be removed before the expiry of his period of office.

(c) MEETINGS OF BOARD

Under Section 285, a meeting of the Board of directors must be held once in every three calendar months; and not more than two months may intervene between the last day of the calendar month in which such meeting is held and the date of the next meeting. The Central Government, however, has power to exempt any class of companies from this provision. Notice of every meeting of the Board must be given in writing to every director in India and to other directors at their usual addresses in India.

The quorum for a meeting of the Board of directors is fixed by Section 287 at one-third of its total strength (any fraction contained in that one-third being rounded off as one) or two directors whichever is *higher*. Under Section 300, an interested director cannot participate or vote in Board's proceedings nor can his presence be counted for the purpose of forming a quorum at the relevant time. If at any time the number of interested directors exceeds or is equal to two-thirds of the total strength, the number of remaining directors, present at the meeting, *but not less than two* shall be the quorum during such time. Under Section 289, a circular resolution cannot be deemed to be passed unless the resolution, together with the necessary papers, has been circulated to all the directors then in India (being not less than the required quorum) and to all other directors at their usual addresses and has been approved by such directors as are then in India or by a majority of such of them as are entitled to vote on the resolution.

(D) POWERS OF BOARD

The Act makes specific provisions in regard to the powers that may or may not be exercised by the directors and also the manner in which such powers are to be exercised. Section 291 provides that:

(1) Subject to the provisions of this Act, the Board of directors of a company shall be entitled to exercise all such powers, and to do all acts and things, as the company is authorised to exercise and do:

Provided that the Board shall not exercise any power or do any act or thing which is directed or required, whether by this or any other Act or by the memorandum or articles of the company or otherwise, to be exercised or done by the company in general meeting:

Provided further that in exercising any such power or doing any such act or thing, the Board shall be subject to the provisions contained in that behalf in this or any other Act, or in the memorandum or articles of the company, or in any regulations not inconsistent therewith and duly made thereunder, including regulations made by the company in general meeting.

(2) No regulation made by the company in general meeting shall invalidate any prior act of the Board which would have been valid if that regulation had not been made.

Section 292 provides that the Board of directors of a company shall exercise the following powers, on behalf of the company, and it shall do so only by means of resolutions passed at meetings of the Board:

(*a*) the power to make calls on shareholders in respect of money unpaid on their shares;
(*b*) the power to issue debentures;
(*c*) the power to borrow moneys otherwise than on debentures;
(*d*) the power to invest the funds of the company; and
(*e*) the power to make loans.

However, the Board may, by a resolution, delegate the powers specified in clauses (c), (d) and (e) to; (i) any committee of directors; (ii) the managing director; (iii) the managing agent; (iv) secretaries and treasurers; (v) the manager or (vi) any other principal officer of the company or (vii) in the case of a branch office, the principal officer of the branch. The delegation is subject to such conditions as the Board may prescribe in the resolu-

tion which must also specify:

(i) in case of clause (c), the total amount outstanding at any one time upto which moneys may be borrowed by the delegate;

(ii) in case of clause (d), the total amount upto which the funds may be invested and the nature of the investments which may be made, by the delegate;

(iii) in case of clause (e), the total amount upto which loans may be made by the delegate, the purposes for which the loans may be made and the maximum amount of loans which may be made for each such purpose in individual cases.

The transactions of a bank in the ordinary course of its business are not deemed to be either borrowing or making loans. In respect of dealings with its banks, the power specified in clause (c) means the arrangement made by the company with its bankers for the borrowing of moneys by way of overdraft or cash credit or otherwise and not the actual day to day operation on overdraft, cash credit or other accounts by means of which such arrangement is actually availed of.

Section 293 provides that the Board of directors of a public company or of a private company which is a subsidiary of a public company, shall not, except with the consent of the company in general meeting:

(*a*) sell, lease or otherwise dispose of the whole, or substantially the whole, of the undertaking of the company, or where the company owns more than one undertaking, of the whole, or substantially the whole, of any such undertaking;

[However, the said restriction does not apply to the selling or the leasing of any property of the company where the ordinary business of the company consists of, or comprises such selling or leasing.]

(*b*) remit, or give time for the re-payment of, any debt due by a director except in the case of renewal or continuance of an advance made by a banking company to its director in the ordinary course of business;

(*c*) invest, otherwise than in trust securities, the amount of compensation received by the company in respect of the compulsory acquisition, after commencement of this Act, of any such undertaking as is referred to in clause (*a*), or of any premises or properties used for any such undertaking and without which it cannot be carried on or can be carried on only with difficulty or only after a considerable time;

(*d*) borrow moneys after the commencement of this Act, where the moneys to be borrowed, together with the moneys already borrowed by the company (apart from temporary loans obtained from the company's bankers in the ordinary course of business), will exceed the aggregate of the paid-up capital of the company and its free reserves, that is to say, reserves not set apart for any specific purpose; or

(*e*) contribute, after the commencement of this Act, to charitable and other funds not directly relating to the business of the company or the welfare of its employees, any amounts the aggregate of which will, in any financial year, exceed twenty-five thousand rupees, or five per cent. of its average net profits as determined in accordance with the provisions of sections 349 and 350 during the three financial years immediately preceding, whichever is greater.

The expression "temporary loans" in clause (d) means loans repayable on demand or within six months from the date of the loan, such as short term cash credit arrangements, the discounting of bills and the issue of other short term loans of a seasonal character, but does not include loans raised for the purpose of financing expenditure of a capital nature.

A resolution passed by the company in general meeting, in relation to the exercise of the power referred to:

(i) In clause (a), may specify the conditions regarding the use, disposal or investment of the sale proceeds which may result from the transaction.

(ii) In clause (d), shall specify the total amount up to which moneys may be borrowed by the Board of directors:

(iii) In clause (e), shall specify the total amount which may be contributed to charitable and other funds in any financial year.

The acceptance by a banking company, in the ordinary course of its business, of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft, order or otherwise,

shall not be deemed to be a borrowing of moneys by the banking company within the meaning of clause (*d*) of sub-section (1).

Restrictions on the power of the Board of directors to make political contributions contained in Section 293A will be discussed infra § 9, para B.

Under Section 298, the Board of directors are given power to carry on business when the managing agents or secretaries and treasurers have, or are deemed to have, vacated the office, etc.

(E) CONTRACTS WITH DIRECTORS ETC.

If a director is in any way, whether directly or indirectly, concerned or interested in a contract or an arrangement or proposed contract or arrangement with the company, he must disclose the nature of his interest at a meeting of the directors in the manner provided in Section 299. However, this provision shall not apply to any contract or arrangement entered into or to be entered into between two companies where any of the directors of the one company or two or more of them together holds or hold not more than two per cent., of the paid up share capital in the other company. Under Section 299(3) general notice may be given to the Board by a director in respect of contracts with any specified concerns in which he is to be regarded as interested, such notice is deemed to be a sufficient disclosure of his interest. Such general notice shall expire at the end of the financial year in which it is given but may be renewed. An interested director of a company, under Section 300, cannot take part in the discussion of or vote on any such contract or arrangement in which he is interested or concerned, whether directly or indirectly and his presence shall not be counted for the purpose of forming a quorum, subject to exceptions mentioned in Section 300(2).

Section 302 provides for disclosure by a company to its members of interest of a director, where a company:

(*a*) enters into a contract for the appointment of a manager of the company, in which contract any director of the company is in any way, whether directly or indirectly, concerned or interested; or

(*b*) varies any such contract already in existence and in which a director is concerned or interested as aforesaid.

A company must keep a register of contracts, companies and firms in which directors are interested, containing particulars of all contracts or arrangements to which Section 297 or Section 299 applies and other specified particulars in the manner provided by Section 301.

(F) Board's Sanction for Contracts

Section 297 provides that:

(1) Except with the consent of the Board of directors of a company, a director of the company or his relative, a firm in which such a director or relative is a partner, any other partner in such a firm, or a private company of which the director is a member or director, shall not enter into any contract with the company—

(*a*) for the sale, purchase or supply of any goods, materials or services; or

(*b*) after the commencement of this Act, for underwriting the subscription of any shares in, or debentures of, the company.

(2) Nothing contained in clause (a) of sub-section (1) shall affect—

(*a*) the purchase of goods and materials from the company, or the sale of goods and materials to the company, by any director, relative, firm, partner or private company as aforesaid for cash at prevailing market prices; or

(*b*) any contract or contracts between the company on one side and any such director, relative, firm, partner or private company on the other for sale, purchase or supply of any goods, materials and services in which either the company or the director, relative, firm, partner or private company, as the case may be, regularly trades or does business:

Provided that such contract or contracts do not relate to goods and materials the value of which, or services the cost of which, exceeds five thousand rupees in the aggregate in any year comprised in the period of the contract or contracts; or

(*c*) in the case of a banking or insurance company any transaction in the ordinary course of business of such company with any director, relative, firm, partner or private company as aforesaid.

(3) Notwithstanding anything contained in sub-sections (1) and (2), a director, relative, firm, partner or private company as aforesaid may, in circumstances of urgent necessity, enter, without obtaining the consent of the Board, into any contract with the company for the sale, purchase or supply of any goods, materials or services even if the value of such goods or cost of such services exceeds five thousand rupees in the aggregate in any year comprised in the period of the contract; but in

such a case, the consent of the Board shall be obtained at a meeting within three months of the date on which the contract was entered into.

(4) Every consent of the Board required under this section shall be accorded by a resolution passed at a meeting of the Board and not otherwise; and the consent of the Board required under sub-section (1) shall not be deemed to have been given within the meaning of that sub-section unless the consent is accorded before the contract is entered into or within three months of the date on which it was entered into.

(5) If consent is not accorded to any contract under this section, anything done in pursuance of the contract shall be voidable at the option of the Board.

(6) Nothing in this section shall apply to any case where the consent has been accorded to the contract before the commencement of the Companies (Amendment) Act, 1960.

(G) Restrictions on Holding Office or Place of Profit

Section 314 provides that:

(1) Except with the previous consent of the company accorded by a special resolution,—

(*a*) no director of a company shall hold any office or place of profit, and

(*b*) no partner or relative of such a director, no firm in which such a director or relative is a partner, no private company of which such a director is a director or member, and no director, managing agent, secretaries and treasurers, or manager of such a private company shall hold any office or place of profit carrying a total monthly remuneration of five hundred rupees or more, except that of managing director, managing agent, secretaries and treasurers, manager, legal or technical adviser, banker or trustee for the holders of debentures of the company,—

(*i*) under the company; or

(*ii*) under any subsidiary of the company, unless the remuneration received from such subsidiary in respect of such office or place of profit is paid over to the company or its holding company:

Provided that where a relative of a director or a firm in which such a relative is a partner, is appointed to an office or place of profit under the company or a subsidiary thereof without the knowledge of the director, the consent of the company may be obtained within three months from the date of the appointment; and if such consent is not obtained within that period or is refused, the relative or the firm shall be deemed to have vacated his or its office or place on and from the date of expiry of that period and shall be liable to refund to the company any remuneration drawn by him or it for the period immediately preceding that date.

Explanation.—For the purpose of this sub-section, a special resolu-

tion according consent shall be necessary for every appointment in the first instance to an office or place of profit and to every subsequent appointment to such office or place of profit on a higher remuneration not covered by the special resolution, except where an appointment on a time scale has already been approved by the special resolution.

(1A) Nothing in sub-section (1) shall apply where a relative of a director or a firm in which such relative is a partner holds any office or place of profit under the company or a subsidiary thereof having been appointed to such office or place before such director becomes a director of the company.

(2) If any office or place of profit under the company or a subsidiary thereof is held in contravention of the provisions of sub-section (1), the director concerned shall be deemed to have vacated his office as director with effect from the first day on which the contravention occurs; and shall also be liable to refund to the company any remuneration received, or the monetary equivalent of any perquisites or advantage enjoyed by him, in respect of such office or place of profit.

(2A) Every individual, firm, private company or other body corporate proposed to be appointed to any office or place of profit to which this section applies shall, before or at the time of such appointment, declare in writing whether he or it is or is not connected with a director of the company in any of the ways referred to in sub-section (1).

(3) Any office or place shall be deemed to be an office or place of profit under the company within the meaning of sub-section (1),—

(*a*) in case the office or place is held by a director, if the director holding it obtains from the company anything by way of remuneration over and above the remuneration to which he is entitled as such director, whether as salary, fees, commission, perquisites, the right to occupy free of rent any premises as a place of residence or otherwise;

(*b*) in case the office or place is held by an individual other than a director or by any firm, private company or other body corporate, if the individual, firm, private company or body corporate holding it obtains from the company anything by way of remuneration whether as salary, fees, commission, perquisites, the right to occupy free of rent any premises as a place of residence, or otherwise.

(H) Loans to Directors

The provisions of Section 295(1) and (2), in this behalf, are as under:

(1) Save as otherwise provided in sub-section (2), no company (hereinafter in this section referred to as "the lending company") without obtaining the previous approval of the Central Government in that behalf shall, directly or indirectly, make any loan to, or give any guarantee

or provide any security in connection with a loan made by any other person to, or to any other person by,—

(*a*) any director of the lending company or of a company which is its holding company or any partner or relative of any such director;
(*b*) any firm in which any such director or relative is a partner;
(*c*) any private company of which any such director is a director or member;
(*d*) any body corporate at a general meeting of which not less than twenty-five per cent. of the total voting power may be exercised or controlled by any such director, or by two or more such directors together; or
(*e*) any body corporate, the Board of directors, managing director, managing agent, secretaries and treasurers, or manager whereof is accustomed to act in accordance with the directions or instructions of the Board, or of any director or directors, of the lending company.

(2) Sub-section (1) shall not apply to—
(*a*) any loan made, guarantee given or security provided—
(*i*) by a private company unless it is a subsidiary of a public company, or
(*ii*) by a banking company;
(*b*) any loan made—
(*i*) by a holding company to its subsidiary, or
(*ii*) by a company which is the managing agent or secretaries and treasurers of another company to that other company;
(*c*) any guarantee given or security provided—
(*i*) by a holding company in respect of any loan made to its subsidiary, or
(*ii*) by a company which is the managing agent or secretaries and treasurers of another company in respect of any loan made to that other company.

The provisions of Section 295 shall apply to any transaction represented by a book debt which was from its inception in the nature of a loan or an advance.

(1) LIABILITY OF DIRECTORS TO ACCOUNT

The relation between the directors of a company and the company itself has been defined by Lord Selbourne, in *G. E. Rly. Co.* v. *Turner* (1872 8 Ch. 149), when he said: "The directors are the mere trustees or agents of the company—trustees of the company's money and property; agents in the transactions which are

entered into on behalf of the company." As such, directors are liable to account to the company for the assets which have come into their hands or are under their control.

Directors therefore occupy a fiduciary position, and cannot make any profit out of the company beyond the remuneration to which they are entitled, except to the extent provided in the Act and the Articles.

Directors may sustain liability for misfeasance or breach of trust under Section 543 of the Act. Where a claim is made, or there is reason to believe that a claim will be made for misfeasance or breach of trust, he may apply to the Court for relief under Section 633.

It used not to be unusual for a clause to be included in the Articles indemnifying directors and other officers (including auditors) from the consequences of negligence, not amounting to wilful negligence, in the performance of their respective duties, but under Section 201 such provisions are void. Nothing in Section 201 will, however, operate to deprive any person of any exemption or right to be indemnified in respect of anything done or omitted to be done by him whilst any such provision was in force; and a company may still indemnify a director or other officer against any liability incurred by him in defending any proceedings, whether civil or criminal, in which judgment is given in his favour, or in which he is acquitted, as the case may be, or in connection with a successful application for relief under Section 633.

Directors may also be liable for offences committed in the following circumstances:

(1) Under Sections 62 and 63, for authorising the issue of a prospectus containing untrue statements.
(2) Under Section 628, for wilfully making false statements in reports, certificates, Balance Sheets, etc.
(3) Under Section 539, for destruction, mutilation, falsification, etc., of books, papers or securities of a company being wound up.
(4) Under Section 538, for various offences analogous to those applicable to a debtor under the Insolvency Acts.
(5) Under Section 541, where proper books of account have

not been kept by the company throughout the period of two years immediately preceding the commencement of the liquidation of the company or the period between incorporation and the commencement of winding up, whichever is the shorter.

(6) Under Section 209, for failure to keep the necessary books of account for the purpose of recording the prescribed information.

(7) Under Section 210, for failure to take all reasonable steps to comply with the requirements as to placing the accounts before the annual general meeting, etc.

(8) Under Section 211, for failure to comply with the requirements as to form and contents of balance sheet and profit and loss account.

(9) Under Section 212, for failure to comply with the requirements in regard to disclosure of particulars as to subsidiary companies.

(10) Under Section 542, where any business of the company has been carried on with intent to defraud creditors.

(11) Under Section 320, for failure to disclose payment for loss of office, etc.

(12) Under Section 217, for failure to comply with the requirements as to Board's report.

(J) DIRECTORS' TRAVELLING EXPENSES

Unless the Articles specifically provide, a director is not entitled to travelling expenses incurred in attending Board meetings, which are presumably covered by his remuneration (*Young* v. *Naval and Military Co-operative Society*, 1905 1 K.B. 687). It is, however, common to find a provision in the Articles entitling directors to their travelling expenses incurred in attending Board meetings, and power to make such payments is given by clause 65 of Table "A", which also authorises the payment by the company of expenses incurred by directors in travelling on the business of the company.

Where lump sum allowances are made to directors for travelling and entertaining expenses, the auditor must examine the minute of the directors authorising such allowances or the service agreements providing therefor. In such cases the auditor will not

be concerned with the manner in which a director has expended the allowances given to him but he must see that the deduction of tax, wherever applicable, is made. The auditor must also ascertain whether any part of the allowances has been charged to income tax in the hands of a director and, if so, the part included in the total income of the director should be shown separately in the Profit and Loss Account according to Schedule VI, Part II, Clause 4.

Amounts paid to a director in reimbursement of specific expenses incurred by him on the company's behalf, must be vouched with receipts signed by the director, and any supporting vouchers which are available.

(K) THE DIRECTORS' REPORT

A report by the directors of the company must be attached to every Balance Sheet laid before the company in general meeting (Section 217).

The report must contain information with respect to: (i) the state of the company's affairs (ii) the amounts, if any, which the directors propose to carry to reserves (iii) the amount, if any, which they recommend should be paid by way of dividend and (iv) material changes and commitments, if any, affecting the financial position of the company which have occurred between the end of the relevant financial year and the date of the report.

The report must also deal, so far as is material for the appreciation of the state of the company's affairs and not in the opinion of the Board harmful to the business of the company or its subsidiaries, with any changes during the financial year, in the nature of the company's business; in the company's subsidiaries; or in the nature of the business carried on by them. Mention must also be made of any changes generally in the classes of business in which the company has an interest.

On every reservation, qualification or adverse remark contained in the auditors' report, the Board is bound to give the fullest information and explanations in its report, or in cases falling under the proviso to Section 222, in an addendum to that report. The report must be signed by its chairman, if so authorised by the Board, or otherwise by the directors who are required to sign the annual accounts under Section 215. A director, for failure to

comply with the provisions of this section, is liable to imprisonment or fine or both in the manner provided.

(L) REGISTER OF DIRECTORS' SHAREHOLDINGS, ETC.

Section 307 provides that:

(1) Every company shall keep a register showing, as respects each director of the company, the number, description and amount of any shares in, or debentures of, the company or any other body corporate, being the company's subsidiary or holding company, or a subsidiary of the company's holding company, which are held by him or in trust for him, or of which he has any right to become the holder whether on payment or not.

(2) Where any shares or debentures have to be recorded in the said register or to be omitted therefrom, in relation to any director, by reason of a transaction entered into after the commencement of this Act and while he is a director, the register shall also show the date of, and the price or other consideration for, the transaction:

Provided that where there is an interval between the agreement for any such transaction and the completion thereof, the date so shown shall be that of the agreement.

(3) The nature and extent of any interest or right in or over any shares or debentures recorded in relation to a director in the said register shall, if he so requires, be indicated in the register.

(4) The company shall not, by virtue of anything done for the purposes of this section, be affected with notice of, or be put upon inquiry as to, the rights of any person in relation to any shares or debentures.

(5) The said register shall, subject to the provisions of this section, be kept at the registered office of the company, and shall be open to inspection during business hours (subject to such reasonable restrictions as the company may, by its articles or in general meeting, impose, so that not less than two hours in each day are allowed for inspection) as follows:

(*a*) during the period beginning fourteen days before the date of the company's annual general meeting and ending three days after the date of its conclusion, it shall be open to the inspection of any member or holder of debentures of the company; and

(*b*) during that or any other period, it shall be open to the inspection of any person acting on behalf of the Central Government or of the Registrar.

In computing the fourteen days and the three days mentioned in this sub-section, any day which is a Saturday, a Sunday or a public holiday shall be disregarded.

(6) Without prejudice to the rights conferred by sub-section (5), the Central Government or the Registrar may, at any time, require a copy of the said register, or any part thereof.

(7) The said register shall also be produced at the commencement of every annual general meeting of the company and shall remain open and accessible during the continuance of the meeting to any person having the right to attend the meeting.

If default is made in complying with this sub-section the company, and every officer of the company who is in default, shall be punishable with fine which may extend to five hundred rupees.

(8) If default is made in complying with sub-section (1) or (2), or if any inspection required under this section is refused, or if any copy required thereunder is not sent within a reasonable time, the company, and every officer of the company who is in default, shall be punishable with fine which may extend to five thousand rupees and also with a further fine which may extend to twenty rupees for every day during which the default continues.

(9) In the case of any such refusal, the Court may also, by order, compel an immediate inspection of the register.

(10) For the purposes of this section—

(*a*) any person in accordance with whose directions or instructions the Board of directors of a company is accustomed to act, shall be deemed to be a director of the company; and

(*b*) a director of a company shall be deemed to hold, or to have an interest or a right in or over, any shares or debentures, if a body corporate other than the company holds them or has that interest or right in or over them, and either—

(*i*) that body corporate or its Board of directors is accustomed to act in accordance with his directions or instructions; or

(*ii*) he is entitled to exercise or control the exercise of one-third or more of the total voting power exercisable at any general meeting of that body corporate.

(11) The provisions of this section and section 308 shall apply to managing agents, secretaries and treasurers and managers as they apply to directors.

It is the duty of the directors and persons deemed to be directors to make disclosure of their shareholdings to enable the company to comply with the above provisions. (Section 308).

Where the auditor performs a share transfer audit he should see that all transactions by the directors in the company's shares as disclosed thereby are properly recorded in the register of directors' shareholdings, etc. It is not considered necessary, however, in the course of the ordinary audit of the company's accounts that the auditor should attempt to check the accuracy of the entries

made in the register.

Every company must keep at its registered office, a register of its directors, managing director, managing agent, secretaries and treasurers, manager and secretary containing the particulars specified in Section 303(1).

§ 2. Managing Director

"Managing Director" means a director who, by virtue of an agreement with the company or of a resolution passed by the company in general meeting or by its Board of directors or, by virtue of its Memorandum or Articles of association, is entrusted with substantial powers of management which would not otherwise be exercisable by him, and includes a director occupying the position of a managing director, by whatever name called.

Provided that the power to do administrative acts of a routine nature when so authorised by the Board such as the power to affix the common seal of the company to any document or to draw and endorse any cheque on the account of the company in any bank or to draw and endorse any negotiable instrument or to sign any certificate of share or to direct registration of transfer of any share, shall not be deemed to be included within substantial powers of management.

Provided further that a managing director of a company shall exercise his powers subject to the superintendence, control and direction of its Board of directors. [Section 2 (26)].

Section 267 prohibits the appointment of certain persons as managing or whole-time directors.

In case of public company or a private company which is a subsidiary of a public company, permission of the Central Government is required, in the manner provided, in respect of the following:

(i) to amend any provision, wherever contained, relating to the appointment or re-appointment of a managing or whole-time director or a director not liable to retire by rotation. (Section 268).

(ii) to appoint a managing or whole-time director for the first time or to re-appoint them for the first time after the commencement of the Companies (Amendment) Act, 1960.

(Section 269).

(iii) to make any provision relating to the remuneration of any director, including a managing or whole-time director or to amend any provision which purports to increase such remuneration. (Section 310).

(iv) to increase the remuneration of a managing or whole-time director on re-appointment or appointment in place of previous managing or whole-time director. (Section 311).

(v) to appoint the same person to be a managing director of more than two companies at a time. (Section 316).

Such provisions shall not have any effect unless approved by Central Government and they become void if, and so far as, they are disapproved by it.

After the commencement of the Act, no company can appoint any individual as its managing director for a term exceeding five years at a time. However, there is nothing to prohibit the re-appointment, re-employment or the extension of the term of office by further periods not exceeding five years on each occasion, provided it is not done earlier than two years from the date on which it has to come into force. This section does not apply to a private company unless it is a subsidiary of a public company.

§ 3. Managing Agents

According to Section 2(25) "Managing Agent" means any individual, firm or body corporate entitled, subject to the provisions of this Act, to the management of the whole, or substantially the whole, of the affairs of a company by virtue of an agreement with the company or by virtue of its Memorandum or Articles of Association, and includes any individual, firm or body corporate occupying the position of a managing agent, by whatever name called.

(A) APPOINTMENT AND TERM OF OFFICE ETC.

Under Section 324, the Central Government has the power to declare that companies which are engaged in specific classes of industry or business shall not have managing agents. Under Section 325, a company acting as a managing agent of any other

company cannot appoint a managing agent for itself and a company having a managing agent cannot be appointed as a managing agent of any other company.

A company cannot appoint as its managing agent, any body corporate which is a subsidiary, either of itself or of any other body corporate unless immediately before the Companies (Amendment) Act, 1960, the company had any such subsidiary as its managing agent.

A managing agent cannot be appointed or reappointed—

(*a*) except by the company in general meeting; and

(*b*) unless the approval of the Central Government has been obtained for such appointment or reappointment.

Under Section 328, no company shall—

(*a*) in case it appoints a managing agent for the first time (that is to say, in case the company has had no managing agent at any time since its formation), make the appointment for a term exceeding fifteen years;

(*b*) in any other case, re-appoint or appoint a managing agent for a term exceeding ten years at a time;

(*c*) re-appoint a managing agent for a fresh term, when the existing term of the managing agent has two years or more to run.

For this purpose, the meaning of reappointment is clarified. An appointment or re-appointment in contravention of Section 328, is void.

A resolution of the company in general meeting is required for varying the terms of a managing agency agreement; and *before* such a resolution is passed, the previous sanction of the Central Government must be obtained. These provisions apply to all companies, except a private company which is not a subsidiary of a public company if so exempted specifically by the Central Government.

After the 15th day of August, 1960, no person can, at the same time, hold office as managing agent in more than ten companies. For this purpose, the persons described in Section 332 (4) are deemed to hold office as managing agent of the company.

In calculating the number of companies for the purpose of this provision, the following companies shall be excluded; namely:

(*a*) a private company which is neither a subsidiary nor a holding company of a public company;
(*b*) an unlimited company;
(*c*) an association which does not carry on business for profit, or which prohibits the payment of a dividend.

Section 333 provides as under:

A managing agent whose office stands terminated under section 324 or 332 shall be entitled to a charge on the assets of the company in respect of all moneys which are due to him from the company at the date of such termination, or which he may have to pay after that date in respect of any liability or obligation properly incurred by him on behalf of the company before such date, subject to all exsting charges and incumbrances, if any, on such assets.

The managing agent shall be deemed to have vacated the office in the circumstances mentioned in Sections 334 and 336. Section 335 makes provision for suspension of managing agent if a receiver is appointed for his property and Section 337 provides for removal of managing agent from office for fraud or breach of trust. Under Section 338, he can be removed for gross negligence or mismanagement.

Section 342 deals with resignation of office by a managing agent as under:

(1) Unless the managing agency agreement otherwise provides, a managing agent may, by notice to the Board, resign his office as from such date as may be specified in the notice but such resignation shall not be effective until it is accepted by the company under sub-section (7).

(2) The managing agent shall cease to act as such with effect from the date so specified or from such later date, if any, as may be mutually agreed on between him and the Board; but the managing agent shall not be absolved from liability to the company for his acts whether of commission or omission, during the period of his managing agency.

(3) When notice of resignation is given as aforesaid, the Board shall require the managing agent within such time as may be fixed by it or such further time as may be allowed by it, to prepare, and the managing agent shall prepare, a report on the state of affairs of the company as on the date specified in the notice of resignation or such subsequent date as the Board may think suitable, not being later than that on which the managing agent ceases to act as such under sub-section (2), together with a balance-sheet made out as on that date and a profit and loss account for the period commencing from the date up to which the last such account

was prepared and ending with the date on which the managing agent ceases to act as such.

(4) In case of default by the managing agent in complying with the requisition of the Board under sub-section (3), the Board shall itself cause a report on the state of affairs of the company as on the date specified in the notice of resignation or such subsequent date as the Board may think suitable, not being later than that on which the managing agent ceases to act as such under sub-section (2), together with a balance-sheet made out as on that date and a profit and loss account for the period specified in sub-section (3), to be prepared.

(5) The Board shall also obtain a report from the auditors of the company on such balance-sheet and profit and loss account in accordance with sections 227, 228 and 229 and place the managing agent's resignation together with the report on the state of the company's affairs, balance sheet, profit and loss account and auditors' report mentioned above, before the company in general meeting.

(6) In relation to any report made by the auditors as aforesaid, sections 230 to 233 shall apply in like manner as they apply in relation to auditors' report referred to therein.

(7) The company in general meeting may, by a resolution, accept the resignation or take such other action with reference thereto as it may deem fit.

In respect of changes in constitution of managing agency firms or corporations, the approval of the Central Government should be obtained as provided in Section 346.

(B) Restrictions on Managing Agents

Under Section 375, a managing agent is not permitted to engage on his own account (in the manner specified in the Section) in any business which is of the same nature as, and directly competes with the business carried on by a company of which he is the managing agent or by a subsidiary of such company, unless such company by special resolution permits him to do so.

In case he does so, he is deemed to have received all profits and benefits accruing to him from such business, in trust for the company concerned.

Any condition, prohibiting re-construction or amalgamation of company, except on continuance of managing agent etc., is void under Section 376.

The managing agent of a company may, if so authorised by its Articles, appoint not more than two directors where the total number of the directors exceeds five, and one director where the total number does not exceed five, subject to provisions of Sec-

tion 377.

(c) RESTRICTIONS ON APPOINTMENTS AS SELLING AND BUYING AGENTS, ETC.

A managing agent or an associate of a managing agent cannot receive any commission or other remuneration from the company, in respect of sales of goods produced by the managed company, if the sales are made from the premises at which they are produced or from the head office of the managing agent or from any place in India.

However, for sales of goods produced by a company which are effected from any place outside India, not being a place specified as aforesaid, such persons may be appointed as selling agents subject to the conditions specified in Section 356. Such appointment cannot exceed five years but may be renewed in the manner provided in the section. The special resolution required for such appointment must set out the material terms subject to which such appointment is made.

The said provisions equally apply where and in so far as, the business of a company consists in the supply or rendering of any services.

Particulars of such appointment should be entered in a register maintained by the company for the purpose.

Under Section 358, a managing agent or an associate of a managing agent cannot receive any payment whatever, from the company except expenses, if any, sanctioned under Section 354 in respect of purchases of goods made on its behalf either in India, or in cases to which sub-section (2) does not apply, outside India.

Such payments for purchase of goods outside India are permitted subject to the conditions mentioned in the section. The special resolution for this purpose must give the specified particulars and it cannot remain in force for a term exceeding three years but may be renewed in the manner provided. Such resolution should be entered in a register maintained by the company for the purpose.

Section 359 provides that a company in general meeting may, by resolution, authorise its managing agent or his associate to retain any commission or other remuneration earned, under certain

conditions, from other concerns entering into contract with the company provided the prices or amounts charged are at rates which are not less favourable to the company than the market rates or which are otherwise reasonable. Such contract and its particulars should be entered in a separate register maintained by the company for the purpose.

Section 360 (1) provides that:

A contract between a company and its managing agent or an associate of the managing agent,—

(*a*) for the sale, purchase or supply of any property, movable or immovable, or for the supply or rendering of any service other than that of managing agent; or
(*b*) for the underwriting of any shares or debentures to be issued or sold by the company;

shall not be valid against the company—

(*i*) unless the contract has been approved by the company by a special resolution passed by it, and
(*ii*) where the contract is for the supply or rendering of any service other than that of managing agent, unless further the contract has been approved by the Central Government,

either before the date of the contract or at any time within three months next after that date.

The special resolution must contain the particulars specified in the section. Such contract and its particulars should be entered in a separate register maintained by the company for the purpose.

In respect of remuneration received in contravention of the above provisions, Section 363 provides that such receipts should be held in trust for the company.

Under Section 364, any assignment of, or charge on, the remuneration of managing agent is void as against the company but the section does not affect the rights *inter se* of the managing agent and any person other than the company.

(D) RESTRICTIONS ON POWERS

Section 368 provides that the managing agent of a company shall exercise his powers:

(i) subject to the superintendence, control and direction of its Board of directors;

(ii) subject also to the provisions of the Memorandum and Articles of the company; and

(iii) subject to the restrictions contained in Schedule VII.

(E) LOANS TO MANAGING AGENTS

In respect of loans to managing agents, Section 369 provides that

(1) No public company, and no private company which is a subsidiary of a public company, shall directly or indirectly make any loan to, or give any guarantee or provide any security in connection with a loan made by any other person to, or to any other person by,—

(*a*) its managing agent or any associate of its managing agent; or

(*b*) any body corporate in respect of which the Central Government, by order, declares that it is satisfied that the Board of directors, managing director, managing agent, secretaries and treasurers or manager thereof is accustomed to act in accordance with the directions or instructions of the managing agent or associate of the managing agent, notwithstanding that the body corporate may not itself be an associate of the managing agent.

(2) Nothing contained in sub-section (1) or section 295 shall apply to—

(*a*) any credit given by the company to its managing agent for the purpose of facilitating the company's business and held by such agent in his own name in one or more current accounts, subject to limits previously approved by the directors of company and on no account exceeding twenty thousand rupees in the aggregate; or

(*b*) any loan made by a holding company to its subsidiary.

Explanation.—Credit referred to in clause (*a*) of sub-section (2) is confined to any cash advance given by way of a permanent advance or imprest for facilitating the carrying on of the company's business, transactions on such advance or imprest account being settled as far as possible on a monthly basis.

(F) LOANS TO COMPANIES UNDER THE SAME GROUP

The restrictions on loans to companies under the *same management* are provided in Section 370 as under:

(1) No company (hereinafter in this section referred to as "the lending company") shall—

(*a*) make any loan to, or

(*b*) give any guarantee, or provide any security, in connection with a loan made by any other person to, or to any other per-

son by,

any body corporate which is under the same management as the lending company, unless the making of such loan, the giving of such guarantee or the provision of such security has been previously authorised by a special resolution of the lending company.

(1A) Where the lending company—

(*a*) makes any loan to, or

(*b*) gives any guarantee, or provides any security, in connection with a loan made by any other person to, or to any other person by,

a firm in which a partner is a body corporate under the same management as the lending company—

(i) the loan shall be deemed to have been made to, or

(ii) the guarantee or the security shall be deemed to have been given or provided in connection with the loan made by such other person to, or to such other person by,

a body corporate under the same management.

(1B) For the purposes of sub-sections (1) and (1A) two bodies corporate shall be deemed to be under the same management—

(i) if the managing agent, secretaries and treasurers, managing director or manager of the one body, or where such managing agent or secretaries and treasurers are a firm, any partner in the firm, or where such managing agent or secretaries and treasurers are a private company, any director of such company, is—

(*a*) the managing agent, secretaries and treasurers, managing director or manager of the other body; or

(*b*) a partner in the firm acting as managing agent or secretaries and treasurers of the other body; or

(*c*) a director of the private company acting as managing agent or secretaries and treasurers of the other body; or

(ii) if a majority of the directors of the one body constitute. or at any time within the six months immediately preceding constituted, a majority of the directors of the other body; or

(iii) if not less than one-third of the total voting power with respect to any matter relating to each of the two bodies

corporate is exercised or controlled by the same individual or body corporate; or

(iv) if the holding company of the one body corporate is under the same management as the other body corporate within the meaning of clause (i), clause (ii) or clause (iii), or

(v) if one or more directors of the one body corporate while holding, whether by themselves or together with their relatives, the majority of shares in that body corporate also hold, whether by themselves or together with their relatives, the majority of shares in the other body corporate.

The lending company is required to keep a register containing the particulars specified in the section.

The said provisions do not apply to—

(*a*) any loan made—
  (*i*) by a holding company to its subsidiary, or
  (*ii*) by the managing agent or secretaries and treasurers to any company under his or their management, or
  (*iii*) by a banking company in the ordinary course of its business;
(*b*) any guarantee given or any security provided—
  (*i*) by a holding company in respect of any loan made to its subsidiary, or
  (*ii*) by the managing agent or secretaries and treasurers in respect of any loan made to any company under his or their management; or
  (*iii*) by a banking company in the ordinary course of its business.

This section also does not apply to a book debt unless the transaction represented by the book debt was from its inception in the nature of a loan or an advance.

Section 370A makes provision in respect of such loan made before the Companies (Amendment) Act, 1960.

§ 4. Secretaries and Treasurers etc.

(A) SECRETARIES AND TREASURERS

According to Section 2(44) "Secretaries and Treasurers" means—any firm or body corporate (not being the managing agent) which, subject to the superintendence, control and direction of the Board of directors, has the management of the whole,

or substantially the whole, of the affairs of a company; and includes any firm or body corporate occupying the position of secretaries and treasurers, by whatever name called, and whether under a contract of service or not.

A company may appoint a firm or body corporate as its secretaries and treasurers. The provisions applicable to managing agents are made applicable to secretaries and treasurers subject to the provisions of Sections 379 to 383. The provisions of Section 324 prohibiting appointments of managing agents in certain cases and the provisions in Section 332 on restrictions on number of managing agencies do not apply to secretaries and treasurers. They cannot have a right to appoint a director of a company. Unless and except to the extent to which they are authorised by the Board of directors, secretaries and treasurers have no right, to sell any goods or articles manufactured or produced by the company or to purchase, obtain, or acquire machinery, stores, goods or materials for the purposes of the company, or to sell the same when no longer required for those purposes.

(B) MANAGER

Under Section 2(24) "Manager" means an individual (not being the managing agent) who, subject to the superintendence, control and direction of the Board of directors, has the management of the whole, or substantially the whole, of the affairs of a company, and includes a director or any other person occupying the position of a manager, by whatever name called, and whether under a contract of service or not.

Section 384 provides that a company cannot appoint any firm, body corporate or association as its manager. Further Section 385 provides that certain persons cannot be appointed as managers.

A company, other than a private company which is not a subsidiary of a public company, cannot appoint any person as its manager, if he is either the manager or the managing director of any other company except as provided in Section 386 (2).

(C) SECRETARY

Under the Act, "Secretary" means any individual, firm or body corporate appointed to perform the duties which may be per-

formed by a secretary under the Act and any other purely ministerial or administrative duties.

(D) RESTRICTION ON APPOINTMENT OF FIRMS OR BODIES CORPORATE TO OFFICES

Except as provided in Section 204 (2) a company cannot appoint or employ any firm or body corporate to or in any office or place of profit under the company, other than the office of managing agent, secretaries and treasurers, or trustee for the holders of debentures of the company, for a term exceeding five years at a time and in case of initial appointment, not exceeding ten years, with the approval of the Central Government. Exceptions have been made in respect of technicians or consultants. These provisions do not apply to a private company, unless it is a subsidiary of a public company.

§ 5. Managerial Personnel

Under Section 197A, simultaneous appointment of different categories of managerial personnel is prohibited. After the commencement of the Companies (Amendment) Act, 1960, no company shall appoint or employ at the same time or after the expiry of six months from such commencement, more than one of the following categories of managerial personnel, namely:

(*a*) managing director,
(*b*) managing agent,
(*c*) secretaries and treasurers, and
(*d*) manager.

§ 6. Managerial Remuneration

(A) OVERALL MANAGERIAL REMUNERATION

Section 198, which deals with maximum managerial remuneration and managerial remuneration in case of absence or inadequacy of profits is as under:

(1) The total managerial remuneration payable by a public company or a private company which is a subsidiary of a public company, to its directors and its managing agent, secretaries and treasurers or manager in respect of any financial year shall not exceed eleven per cent. of the net profits of that company for that financial year computed in the man-

ner laid down in sections 349, 350 and 351, except that the remuneration of the directors shall not be deducted from the gross profits;

Provided that nothing in this section shall affect the operation of Sections 352 to 354 and 356 to 360.

(2) The percentage aforesaid shall be exclusive of any fees payable to directors under sub-section (2) of Section 309.

(3) Within the limits of the maximum remuneration specified in sub-section (1), a company may pay a monthly remuneration to its managing or whole-time director in accordance with the provisions of section 309 or to its manager in accordance with the provisions of section 387.

(4) Notwithstanding anything contained in sub-sections (1) to (3), if in any finacial year, a company has no profits or its profits are inadequate, the company may, subject to the approval of the Central Government, unless such approval has been obtained under any other provision of this Act, pay to its directors (including any managing or whole-time director), its managing agent, secretaries and treasurers, or manager or if there are two or more of them holding office in the company, to all of them together by way of minimum remuneration, such sum not exeeding fifty thousand rupees per annum exclusive of any fees payable to directors under sub-section (2) of section 309 as it considers reasonable:

Provided that where a monthly payment is being made or is proposed to be made to any managing or whole-time director or the manager or to any one or more of them and the Central Government is satisfied that for the efficient conduct of the business of the company the minimum remuneration of fifty thousand rupees per annum is or will be insufficient, the Central Government may by order sanction an increase in the minimum remuneration to such sum, for such period and subject to such conditions, if any, as may be spiecfied in the order.

Explanation.—For the purposes of this section and sections 309, 310, 311, 348, 352, 381 and 387, "remuneration" shall include,——

(*a*) any expenditure incurred by the company in providing any rent-free accommodation, or any other benefit or amenity in respect of accommodation free of charge, to any of the persons specified in sub-section (1);

(*b*) any expenditure incurred by the company in providing any other benefit or amenity free of charge or at a concessional rate to any of the persons aforesaid;

(*c*) any expenditure incurred by the company in respect of any obligation or service which, but for such expenditure by the company, would have been incurred by any of the persons aforesaid; and

(*d*) any expenditure incurred by the company to effect any insurance on the life of, or to provide any pension, annuity or gratuity for, any of the persons aforesaid or his spouse or child.

Section 199 provides that where any commission or other remuneration payable to any officer or employee of a company (not

being a director, the managing agent, secretaries and treasurers or a manager) is fixed at a percentage of, or is otherwise based on, the net profits of the company, such profits must be calculated in the manner set out in Sections 349, 350 and 351, which are as under:

349. (1) In computing for the purpose of section 348, the net profits of a company in any financial year—

(*a*) credit shall be given for the sums specified in sub-section (2), and credit shall not be given for those specified in sub-section (3); and

(*b*) the sums specified in sub-section (4) shall be deducted, and those specified in sub-section (5) shall not be deducted.

(2) In making the computation aforesaid, credit shall be given for the following sums:

bounties and subsidies received from any Government, or any public authority constituted or authorised in this behalf, by any Government, unless and except in so far as the Central Government otherwise directs.

(3) In making the computation aforesaid, credit shall not be given for the following sums:

(*a*) profits, by way of premium, on shares or debentures of the company, which are issued or sold by the company;

(*b*) profits on sales by the company of forfeited shares;

(*c*) profits of a capital nature including profits from the sale of the undertaking or any of the undertakings of the company or of any part thereof;

(*d*) profits from the sale of any immovable property or fixed assets of a capital nature comprised in the undertaking or any of the undertakings of the company, unless the business of the company consists, whether wholly or partly, of buying and selling any such property or assets:

Provided that where the amount for which any fixed asset is sold exceeds the written-down value thereof referred to in section 350, credit shall be given for so much of the excess as is not higher than the difference between the original cost of that fixed asset and its written-down value.

(4) In making the computation aforesaid, the following sums shall be deducted:

(*a*) all the usual working charges;

(*b*) directors' remuneration;

(*c*) bonus or commission paid or payable to any member of the company's staff, or to any engineer, technician or person employed or engaged by the company, whether on a whole-time or on a part-time basis;

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

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

(*f*) interest on debentures issued by the company;

(*g*) interest on mortgages executed by the company and on loans and advances secured by a charge on its fixed or floating assets;

(*h*) interest on unsecured loans and advances;

(*i*) expenses on repairs, whether to immovable or to movable property, provided the repairs are not of a capital nature;

(*j*) outgoings inclusive of contributions made under clause (*e*) of sub-section (1) of section 293;

(*k*) depreciation to the extent specified in section 350;

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

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

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

(*o*) debts considered bad and written off or adjusted during the year of account.

(*5*) In making the computation aforesaid, the following sums shall not be deducted:

(*a*) the remuneration payable to the managing agent;

(*b*) income-tax and super-tax payable by the company under the Indian Income-tax Act, 1922, or any other tax on the income of the company not falling under clauses (*d*) and (*e*) of sub-section (4);

(*c*) any compensation, damages or payments made voluntarily, that is to say, otherwise than in virtue of a liability such as is referred to in clause (*m*) of sub-section (4);

(*d*) loss of a capital nature including loss on sale of the undertaking or any of the undertakings of the company or of any part thereof not including any excess referred to in the proviso to section 350 of the written-down value of any asset which is sold, discarded, demolished or destroyed over its sale proceeds or its scrap value.

350. The amount of depreciation to be deducted in pursuance of clause (*k*) of sub-section (4) of section 349 shall be the amount calculated with reference to the written-down value of the assets as shown by the books of the company at the end of the financial year expiring at the commencement of this Act or immediately thereafter and at the end of each subsequent financial year, at the rate specified for the assets by the Indian Income-tax Act, 1922, and the rules made thereunder for the time being in force, as normal depreciation including therein extra

and multiple shift allowances but not including therein any special, initial or other depreciation or any development rebate, whether allowed by that Act or those rules or otherwise:

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

351. Where there is an arrangement between two or more companies to share their profits, and not less than two of those companies have the same managing agent, any profits paid in pursuance of the arrangement by any of the companies having that managing agent to any other or others of them shall--

(*a*) be excluded from the net profits of the company making such payment; and

(*b*) be included in the net profits of the company receiving such payment, or where more than one company receives such payment, be included in the net profits of each of the receiving companies, to the extent of the payment received by it.

(B) Remuneration of Directors

The remuneration payable to the directors of a company is governed by Section 309 which is as under:

(1) The remuneration payable to the directors of a company, including any managing or whole-time director, shall be determined, in accordance with and subject to the provisions of section 198 and this section, either by the articles of the company, or by a resolution or, if the articles so require, by a special resolution, passed by the company in general meeting.

(2) A director may receive remuneration by way of a fee for each meeting of the Board, or a committee thereof, attended by him:

Provided that where immediately before the commencemnt of the Companies (Amendment) Act, 1960, fees for meetings of the Board and any committe thereof, attended by a director are paid on a monthly basis, such fees may continue to be paid on that basis for a period of two years after such commencement or for the remainder of the term of office of such director, whichever is less, but no longer.

(3) A director who is either in the whole-time employment of the company or a managing director may be paid remuneration either by way of a monthly payment or at a specified percentage of the net profits of the company or partly by one way and partly by the other:

Provided that except with the approval of the Central Government such remuneration shall not exceed five per cent of the net profits for one such director, and if there is more than one such director ten per cent for all

of them together.

(4) In the case of a director who is neither in the whole-time employment of the company nor a managing director and whose remuneration does not include anything by way of a monthly payment, the company may, by special resolution, authorise the payment, to such director, or where there is more than one such director, to all of them together—

(*a*) if the company has a managing or whole-time director, a managing agent or secretaries and treasurers, or a manager, of a commission not exceeding one per cent of the net profits of the company;

(*b*) in any other case, of a commission not exceeding three per cent of the net profits of the company:

Provided that the company in general meeting may, with the approval of the Central Government, authorise the payment of commission at a rate exceeding one per cent, or as the case may be three per cent of its net profits.

(5) The net profits referred to in sub-sections (3) and (4) shall be computed in the manner referred to in section 198, sub-section (1).

(5*A*) If any director draws or receives, directly or indirectly, by way of remuneration any such sums in excess of the limit prescribed by this section or without the prior sanction of the Central Government, where it is required, he shall refund such sums to the company and until such sum is refunded, hold it in trust for the company.

(5*B*) The company shall not waive the recovery of any sum refundable to it under sub-section (5*A*) unless permitted by the Central Government.

(6) No director of a company who is in receipt of any commission from the company and who is either in the whole-time employment of the company or a managing director shall be entitled to receive any commission or other remuneration from any subsidiary of such company.

(7) The special resolution referred to in sub-section (4) shall not remain in force for a period of more than five years; but may be renewed, from time to time, by special resolution for further periods of not more than five years at a time:

Provided that no renewal shall be effected earlier than one year from the date on which it is to come into force.

(8) The provisions of this section shall come into force immediately on the commencement of this Act or, where such commencement does not coincide with the end of a financial year of the company, with effect from the expiry of the financial year immediately succeeding such commencement.

(9) The provisions of this section shall not apply to a private company unless it is a subsidiary of a public company.

Sections 310 and 311 provide for Central Government's sanction in regard to directors' remuneration in certain cases. Table

A, Article 65 provides that the remuneration of the directors shall in so far as it consists of a monthly payment, be deemed to accrue from day to day.

(c) Remuneration of Managing Agents

Section 348, which deals with remuneration of managing agents reads as under:

(1) A company shall not pay to its managing agent, in respect of any financial year beginning at or after the commencement of this Act, by way of remuneration, whether in respect of his services as managing agent or in any other capacity, any sum in excess of ten per cent. of the net profits of the company for that financial year.

(2) For the purposes of this section, any payment made by way of remuneration to any of the following persons shall be deemed to be included in the remuneration of the managing agent:

(*a*) where the managing agent of the company is a firm, every partner in the firm;

(*b*) where the managing agent of the company is a public company, every director of that public company;

(*c*) where the managing agent of the company is a private company, every director and member of that private company.

(3) Nothing contained in sub-section (1) or sub-section (2) shall be deemed to affect the operation of sections 352, 354 and 356 to 360.

Section 352 provides that additional remuneration in excess of the limits specified in Sections 198 and 348 may be paid to the managing agent provided such remuneration is sanctioned by a special resolution and approved by the Central Government as being in the public interest.

Until the accounts of the company for the financial year or part thereof have been audited and laid before the company in its general meeting, the remeuneration payable to the managing agent cannot be paid. But the minimum remuneration may be paid in suitable instalments if there is a specific provision in the Articles or in the managing agency agreement or in a resolution passed by the company at its general meeting.

The managing agent cannot be paid any office allowances but he may be reimbursed in respect of any expenses incurred by him on behalf of the company.

The provisions of Sections 348 to 354 do not apply to a private company which is not a subsidiary of a public company.

(D) Remuneration of Secretaries and Treasurers and Managers

The provisions of Section 348 apply to secretaries and treasurers subject to the modification that they cannot be paid remuneration in excess of seven and a half per cent. of the "net profits."

The manager of a company may, subject to the provisions of Section 198, receive remuneration either by way of a monthly payment, or by way of a specified percentage, of the net profits of the company calculated in the manner laid down in Sections 349, 350 and 351 or partly by the one way and partly by the other. However such remuneration cannot exceed in the aggregate five per cent. of the net profits except with the approval of the Central Government. This provision does not apply to a private company unless it is a subsidiary of a public company.

The requirements as to disclosure of managerial remuneration (Schedule VI Part II), in the Profit and Loss Account are discussed in Chapter X.

§ 7. Compensation for Loss of Office

Under Section 365, a company is not permitted to pay any compensation, for the loss of office, to its managing agent, in the circumstances mentioned therein. Where payment of compensation to managing agent for loss of office is permitted, under Section 366, it shall not exceed the remuneration which he would have earned, if he had been in office for the unexpired residue of his term, or for three years whichever is shorter. For this purpose, the remuneration should be calculated on the basis of the average remuneration actually earned by him during a period of three years immediately preceding the date on which his office ceased or was terminated, or where he held the office for less than three years, during such period. However, in the event of winding up of the company within a specified period, a further restriction is laid down.

Under Section 318, compensation for loss of office, etc., to a managing director or a whole-time director or directors who are managers is permitted except in the cases specified in sub-section (3) and subject to the limit specified in sub-section (4). No such

payment may be made by the company to any other director.

Sections 319 and 320 prohibit payment of compensation for loss of office to a director in connection with transfer of undertaking or property or transfer of shares in the circumstances mentioned therein.

The requirements as to disclosure of the compensation for loss of office in the Profit and Loss Account are discussed in Chapter X.

§ 8. Minute Books

Section 193 provides that:

(1) Every company shall cause minutes of all proceedings of every general meeting and of all proceedings of every meeting of its Board of directors or of every committee of the Board, to be kept by making within fourteen days of the conclusion of every such meeting concerned, entries thereof in books kept for that purpose with their pages consecutively numbered.

(1*A*) Each page of every such book shall be initialled or signed and the last page of the record of proceedings of each meeting in such books shall be dated and signed—

(*a*) in the case of minutes of proceedings of a meeting of the Board or of a committee thereof, by the chairman of the said meeting or the chairman of the next succeeding meeting;

(*b*) in the case of minutes of proceedings of a general meeting, by the chairman of the same meeting within the aforesaid period of fourteen days or in the event of the death or inability of that chairman within that period, by a director duly authorised by the Board for the purpose.

(1*B*) In no case the minutes of proceedings of a meeting shall be attached to any such book as aforesaid by pasting or otherwise.

(2) The minutes of each meeting shall contain a fair and correct summary of the proceedings thereat.

(3) All appointments of officers made at any of the meetings aforesaid shall be included in the minutes of the meeting.

(4) In the case of a meeting of the Board of directors or of a committee of the Board, the minutes shall also contain—

(*a*) the names of the directors present at the meeting; and

(*b*) in the case of each resolution passed at the meeting, the names of the directors, if any, dissenting from, or not concurring in, the resolution.

(5) Nothing contained in sub-sections (1*A*) to (4) shall be deemed to require the inclusion in any such minutes of any matter which, in the opinion of the chairman of the meeting—

(*a*) is, or could reasonably be regarded as, defamatory of any person;

(*b*) is irrelevant or immaterial to the proceedings; or

(*c*) is detrimental to the interests of the company.

Explanation.—The chairman shall exercise an absolute discretion in regard to the inclusion or non-inclusion of any matter in the minutes on the grounds specified in this sub-section.

(6) If default is made in complying with the foregoing provisions of this section in respect of any meeting, the company, and every officer of the company who is in default, shall be punishable with fine which may extend to fifty rupees.

Minutes of meetings kept in accordance with the provisions of Section 193 are evidence of the proceedings recorded therein. (Section 194).

(A) DIRECTORS' MINUTE BOOK

The auditor should persue the minute book and should see that all minutes which he is utilising as evidence of transactions are duly signed, and that the names of the directors present at the meeting have been inserted. The auditor should refer to the minute book in vouching all transactions other than those connected with the usual trading operations.

The following are instances of transactions of a special nature:

(1) Allotment of shares.
(2) Adoption of contracts.
(3) Authorising the use of the company's seal.
(4) Making calls.
(5) Forfeiting shares.
(6) Appointment and remuneration of managing agents, selling agents, managing director, manager, secretary, or other officials.
(7) Appointment of auditors prior to the first annual general meeting, or to fill a casual vacancy, and fixing their remuneration.
(8) Authorisation of capital expenditure.
(9) Resolution to pay interim dividends where such are *intra vires*.
(10) Payment of travelling expenses or special remuneration to directors.
(11) Adoption of accounts.
(12) Adoption of directors' report to the members and recommendations as to division of profits.

(13) Resolutions in respect of:
  (*a*) Issue of debentures;
  (*b*) Borrowing moneys otherwise than on debentures. (Section 292).
(14) Resolution to make investments. (Sections 292 and 372).
(15) Board's sanction for contracts in which particular directors are interested (Section 297).
(16) Other matters affecting accounts, in respect of which, under the provisions of Companies Act, sanction of the Board is necessary.

(B) MEMBERS' MINUTE BOOK

The auditor should examine the minutes of each meeting, particularly with reference to the following matters:

(1) Adoption of accounts.
(2) The declaration of dividends.
(3) Remuneration voted to directors.
(4) The remuneration of auditors and, where appropriate, their election.
(5) Matters pertaining to accounts which are required to be sanctioned by special resolutions.
(6) Any resolutions affecting the accounts.

In no case, the minutes of proceedings of a meeting shall be attached to the minute book by pasting or otherwise.

§ 9. Miscellaneous Provisions

(A) PROHIBITION OF TAX FREE PAYMENTS. (Section 200)

A company cannot pay to any officer or employee, remuneration, free of any tax (including any kind of income tax and super tax) or otherwise calculated by reference to, or varying with, any tax payable by him, or the rate or standard rate of any such tax, or the amount thereof. The restriction applies to remuneration paid to such persons in any capacity whatsoever. Any provisions or commitments made prior to the commencement of the Act are valid only for the residue of the term, as if it provided instead for the payment of a gross sum subject to the tax in question, which, after deducting such tax, would yield the net sum actually

specified in such provision. The prohibition does not apply to remuneration relating to any period before the commencement of the Act.

Exception is provided by Section 10(6) (vii), Income Tax Act, 1961, under which a company is permitted to pay tax free salary to a foreign technician under certain circumstances.

(B) Contributions to Political Parties and National Defence Fund

Section 293A imposes restrictions on the power of the general meeting and the Board of directors to make contributions to any political party or to any individual or body for any political purpose. The amount of such contributions cannot exceed Rs. 25,000 or five per cent. of the average net profits of the company as determined in accordance with the provisions of Sections 349 and 350 during the three financial years immediately preceding, *whichever is greater.*

The company must disclose in its profit and loss account the particulars of such contributions, amount contributed and name of the party or individual or body to whom such amount has been contributed.

Under Section 293B, the Board of directors, notwithstanding the provisions of Sections 293 and 293A or the Memorandum, Articles or any other instrument relating to the company, may contribute such amount as it thinks fit to the National Defence Fund or any other fund approved by the Central Government for the purpose of National Defence.

The company must disclose in its Profit and Loss Account the total amount contributed to such funds during the financial year to which the account relates.

(C) Employees' Securities and Provident Fund

Any money or security deposited with a company by any of its employee, in pursuance of his contract of service with the company, must be deposited within fifteen days in a post office savings bank account or in a special account in the State Bank of India or in a Scheduled Bank or where the company is a Scheduled Bank in a special account in itself. Such moneys or securities cannot be utilised by the company except for the purposes agreed to in the

contracts of service. (Section 417).

In respect of provident fund constituted by a company for the benefit of its employees, Section 418 provides that all contributions to such fund (whether by the company or by the employees) and income thereon shall be deposited either in the above manner or invested in the securities mentioned or referred to in clauses (a) to (e) of Section 20 of the Indian Trusts Act, 1882. These provisions however, do not prohibit advances or withdrawals permitted under the rules of the fund.

The rate of interest payable on the amount to the credit of an employee should not exceed the rate of interest yielded by the investments of the fund.

In case where trust has been created in respect of any provident fund, the company must collect the contributions of the employees and pay such contributions as well as its own contributions to the trustees within fifteen days from the date of collection, but in other respects, the obligations laid on the company under Section 418 shall devolve on and be discharged by the trustees of the fund.

Under Section 419, an employee is entitled, on request, to see the bank's receipt for any money or security referred to in Sections 417 and 418.

(D) APPOINTMENT OF SOLE SELLING AGENTS. (Section 294)

After the commencement of the Companies (Amendment) Act, 1960, a company cannot appoint a sole selling agent for any area for a term exceeding five years at a time, but re-appointment or extension of the term for periods not exceeding five years, on each occasion, is permitted. Such appointment by directors is subject to approval by the company in the first general meeting held after the appointment has been made. If the company in general meeting disapproves, the appointment ceases to be valid with effect from the date of that general meeting.

Where at any time during 1st April 1956 and 28th Decemeber 1960, a managing agency has been converted into a sole selling agency, the appointment shall become void and inoperative, unless approved by the Central Government within six months of the commencement of the Companies (Amendment) Act, 1960.

No managing agent who has ceased to hold office as such before

the amending Act or after the same, shall be appointed as sole selling agent of the same company within three years from his ceasing to be the managing agent, except with the approval of the Central Government.

Where a company has a sole selling agent, Central Government may conduct an inquiry into whether the terms and conditions of the appointment are prejudicial to the interests of the company. If the Central Government is of the opinion that the terms and conditions are prejudicial to the interests of the company, it may, by order, vary its terms and conditions effective from the date specified by the Central Government.

The Central Government has also reserved the power, in cases where there are more than one selling agents in any area or areas, to make inquiry and to declare any one of these selling agents to be a sole selling agent, if it is of the opinion that, that selling agent is, to all intents and purposes, the sole selling agent for such area. In this case, the appointment of such sole selling agent shall be regulated by the terms and conditions as varied by the Central Government.

CHAPTER X

THE AUDIT OF A LIMITED COMPANY

§ 1. The Books of Account and Statutory Registers, etc.

As indicated in Article 4 of Chapter VII, it is the duty of the auditor to make a report on the accounts examined by him, and on every Balance Sheet and Profit and Loss Account and on every other document required by the Act to be part of or annexed to the Balance Sheet or Profit and Loss Account, laid before the company in general meeting during his tenure of office.

(A) THE BOOKS OF ACCOUNT

Section 209 of the Act provides that, every company shall cause to be kept proper books of account with respect to—

(*a*) all sums of money received and expended by the company and the matters in respect of which the receipt and expenditure take place;
(*b*) all sales and purchases of goods by the company; and
(*c*) the assets and liabilities of the company.

The section further provides that proper books of account shall not be deemed to be kept with respect to the above matters, if there are not kept such books as are necessary to give a true and fair view of the state of the affairs of the company or branch office, as the case may be, and to explain its transactions. The aforesaid books must be kept at the registered office of the company or at such other place *in India* as the Board of directors may decide and in that case the company must within seven days of the decision, file with the Registrar a notice in writing giving the full address of that other place.

Such notice should be given in Form No. 23A of the Companies (Central Government's) General Rules and Forms, 1956, which is as under:

Registration No. of Company ..... Nominal Capital Rs. .....

THE COMPANIES ACT, 1956

Notice of address at which books of account are maintained

Pursuant to proviso under Section 209(1)
Name of Company ..... Limited/Private Limited/ .....
Presented by .....
..... Limited/Private Limited hereby gives you notice pursuant to the proviso to sub-section (1) of section 209 of the Companies Act, 1956, that the Board of Directors of the company have decided vide resolution dated the ..... day of ..... 19..... to keep the books of account of the company at the following address:

(Give full address)

Signature
Designation[α]

Dated the .... day of .... 19.....

[α] State whether Director, Managing/whole-time Director, Managing Agent, Secretaries and Treasurers, Manager or Secretary.

Where a company has a branch office either in India or outside, the company is deemed to have complied with the above mentioned provisions if proper books of account relating to the transactions effected at the branch office are kept at that office and proper summarised returns, made up to dates at intervals of not more than three months, are sent by the branch office to the company at its registered office or the other place where the books of account of the company are kept.

Under Section 2 (9), "branch office" in relation to a company means—

(*a*) any establishment described as a branch by the company; or
(*b*) any establishment carrying on either the same or substantially the same activity as that carried on by the head office of the company; or
(*c*) any establishment engaged in any production, processing or manufacture, but does not include any establishment specified in any order made by the Central Government under Section 8.

The section further requires that the books of account of every company relating to a period of not less than eight years immediately preceding the current year must be preserved in good order and in the case of a company incorporated less than eight years before the current year, the books of account for the entire period preceding the current year must be so preserved.

The books of account are open to inspection by any director during business hours but they are not open to inspection by shareholders or any other person except in the manner provided in the Articles. Table A, Article 95 provides that the Board shall, from time to time, determine whether and to what extent and at what times and places and under what conditions or regulations, the accounts and books of the company, or any of them, shall be open to the inspection of members not being directors. No member (not being a director) shall have any right of inspecting any account or book or document of the company except as conferred by law or authorised by the Board or by the company in general meeting.

The books of account are also open to inspection by the Registrar or any officer of Government authorised by the Central Government if, in the opinion of the Registrar or such officer, sufficient cause exists for the inspection of the books of account.

Under Section 214, a holding company may, by resolution, authorise representatives named in the resolution to inspect the books of account kept by any of its subsidiaries; and the books of account of any such subsidiary shall be open to inspection by those representatives at any time during business hours.

If any person referred to in Section 209(6) fails to take all reasonable steps to secure compliance with the requirements of Section 209, or has, by his own wilful act, been the cause of any

default by the company, he is punishable, in respect of each offence, with imprisonment for a term not exceeding six months or with a fine up to Rs. 1,000 or with both. It will be a defence to any action brought against such person to prove that a competent and reliable person was charged with the duty of seeing that those requirements were complied with and was in a position to discharge that duty. A person cannot be sentenced to imprisonment, unless the offence was committed wilfully.

Where a person other than a person referred to in Section 209 (6) has been charged by the managing agent, secretaries and treasurers, managing director, manager or Board of directors, as the case may be, with the duty of seeing that the requirements of Section 209 are complied with, makes default in doing so, he is punishable, in respect of each offence, with imprisonment for a term not exceeding six months or with a fine up to Rs. 1,000 or with both. It may be noted that such a person may become liable even if the offence is not committed wilfully.

Under Section 541 it is provided that if proper books of account are not kept throughout the period of two years immediately preceding the commencement of the winding-up of a company or the period between the incorporation of the company and the commencement of the winding-up, whichever is shorter, every officer of the company who was in default is liable to imprisonment for a term not exceeding one year unless he can show that he acted honestly and that in the circumstances in which the business was carried on, the default was excusable. For the purposes of this section, such books and accounts must be kept, as are necessary to exhibit and explain the transactions and financial position of the business of the company, so as to contain entries from day to day in sufficient detail of all cash received and paid and where the business of the company has involved dealings in goods, statements of the annual stocktakings and (except in the case of goods sold by way of ordinary retail trade) of all goods sold and purchased, showing the goods and the buyers and sellers thereof in sufficient detail to enable those goods and those buyers and sellers to be identified.

These provisions are analogous to those contained in Section 209, but it will be observed that in the event of liquidation, failure to keep stocktaking statements will render the officers liable to

penalties.

It will be remembered that under Section 227 the specific duty is imposed upon the auditor to report to the members "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."

Section 600(3) provides that—

> The provisions of section 209 shall apply to a foreign company to the extent of requiring it to keep at its principal place of business in India the books of account referred to in that section, with respect to moneys received and expended, sales and purchases made, and assets and liabilities, in the course of or in relation to its business in India.

It is emphasised that this duty must be discharged irrespective of the size of the company—there is no distinction for this purpose between a large public company and a small private company.

(B) Statutory Registers

In addition to, the books of account and minute books, a company is required, under the provisions of the Act, to maintain the following registers:

	Sections
1. Register and index of members	150 & 151
2. Register and index of debenture holders ..	152
3. Foreign register and duplicate of foreign register of members and debenture holders ..	157 & 158
4. Register of charges	143
5. Register of investments of a company which are not held by it in its own name ..	49
6. Register of investments in shares and debentures of other companies	372
7. Register of loans made, guarantees given or securities provided to companies under the same management	370

	Sections
8. Register of directors, managing director, managing agent, secretaries and treasurers, manager and secretary	303
9. Register of shareholdings of directors, managing agents, secretaries and treasurers and managers	307
10. Register of contracts, companies and firms in which directors are directly or indirectly interested	301
11. Register of contracts between managing agent or his associate and the company for the sale or purchase of goods or the supply of services, etc.	360
12. Register containing particulars of appointment of managing agent or his associate as selling agent for goods produced by the company ..	356
13. Register containing particulars of appointment of managing agent or his associate for procuring business from any place outside India where the business of the company consists in supply or rendering of services	357
14. Register containing particulars of appointment of a managing agent or his associate as buying agent for the company	358
15. Register of contracts with the company by other concerns in respect of which the managing agent or his associate is permitted to retain the benefits	359

The register and index of members as well as of debenture holders are required to be kept usually at the registered office of the company in the manner provided in Section 163. Section 164 provides that the register of members, the register of debenture holders, and the annual returns, certificates and statements referred to in Sections 159, 160 and 161 shall be *prima facie* evidence of any matters directed or authorised to be inserted therein by the Act.

The auditor of a company is entitled to have access to and ins-

pect any of the above registers and he should do so to the extent necessary for the purposes of audit.

§ 2. Provisions relating to Annual Accounts

(A) ANNUAL GENERAL MEETING

Under Section 166, every company is required to hold in each year a general meeting as its annual general meeting and the notice calling such meeting should specify the meeting as such. Such meetings have to be held in addition to any other meeting the company may be required to hold. The time interval between two annual general meetings must not be more than fifteen months. A company may hold its first annual general meeting within a period of not more than eighteen months from the date of its incorporation and if such general meeting is held within that time it is not necessary for the company to hold any annual general meeting in the year of its incorporation or in the following year. The Registrar may, for any special reason, extend the time within which annual general meeting may be held, by a period not exceeding three months except in case of the first annual meeting.

Annual general meeting must be called for a time during business hours, not on a public holiday, and should be held either at the registered office of the company or at some other place within the city, town or village in which the registered office of the company is situated, subject to the exemptions which may be granted by the Central Government. Provision is made to enable the company to fix the time for its annual general meetings by its Articles or by a resolution passed at the annual general meeting in the manner provided.

Section 167 gives power to the Central Government to call an annual general meeting in the event of default by the company.

Under Section 173, all business to be transacted at the annual general meeting shall be deemed special, other than:

(*i*) the consideration of the accounts, Balance Sheet and the reports of the Board of directors and auditors,
(*ii*) the declaration of a dividend,
(*iii*) the appointment of directors in the place of those retiring, and

(*iv*) the appointment and remuneration of the auditors.

In case of any other meeting, all business shall be deemed special.

In case where any item of business to be transacted at the meeting is deemed to be special as aforesaid, there should be annexed to the notice of the meeting an explanatory statement setting out all material facts concerning each such item of business, including in particular the nature of the concern or interest therein, of every director, the managing agent, the secretaries and treasurers and the manager, as the case may be. If such item relates to, or affects, any other company, the extent of the shareholding in that other company of the aforesaid persons should be set out in the said statement if the extent of such shareholding interest is not less than twenty per cent. of the paid up share capital of that other company.

(B) ANNUAL ACCOUNTS

Under Section 210, the Board of directors of a company is required to lay before every annual general meeting of the company:

(*a*) a balance sheet as at the end of the period specified in subsection (3); and
(*b*) a profit and loss account for that period.

The period to which the account aforesaid relates is referred to in the Act as a "financial year," which may be less or more than a calendar year but it should not exceed fifteen months. However, the Registrar may, by special permission, extend such period to eighteen months.

Under Section 210(3), in the case of first annual general meeting of the company the profit and loss account should relate, to the period beginning with the incorporation of the company and ending with a day which shall not precede the day of the meeting by more than nine months. In the case of any subsequent annual general meeting the profit and loss account should relate to the period beginning with the day immediately after the period for which the account was last submitted and ending with a day which

shall not precede the day of the meeting by more than six months or in case, where extension has been granted for holding the annual general meeting, it shall not precede the day of the meeting by more than six months and the extension so granted.

In the case of a non-trading company the above provisions will apply as if all references to "profit and loss account", "profit" and "loss" are construed as references respectively to "income and expenditure account," "the excess of income over expenditure," and "the excess of expenditure over income."

For non-compliance with the above provisions a director of the company and any other person having been charged by the Board of directors with the duty of seeing that this section is complied with, are punishable with imprisonment upto six months or a fine upto rupees one throusand or both having regard to the circumstances mentioned in the section.

§ 3. Concept of "True and Fair"

Under the Indian Companies Act, 1913, the annual accounts were required to disclose "a true and correct" view of the state of affairs of a company; whereas the Companies Act, 1956, requires that the annual accounts should disclose "a true and *fair*" view of the state of affairs of the company. The change from "correct" to "fair" is very significant from the point of view of an auditor.

The word *"correct"* denotes that the annual accounts are in accordance with the books of accounts and the emphasis is on mere *reproduction.* Whereas, the word *"fair"* denotes a *representation* as to the state of affairs of the company. Thus the emphasis is shifted from arithmetical accuracy and a mere correspondence of the annual accounts with the books, to the presentation of the accounts in such a manner as to convey a fair view, so far as the balance sheet is concerned, of the state of affairs of the company as at the date thereof; and so far as the profit and loss account is concerned, of the profit or loss for the financial year.

The auditor must see that the accounts present a financial picture which is fair to the shareholders. To achieve this object, the auditor should not merely rely on the books of accounts but he should go behind the transactions recorded in the books so as to ensure that the true effect of all the transactions is reflected in the financial statements.

The concept of "true and fair" implies an absence of window dressing, i.e. an attempt to show the position of the concern better than it is, either by inflating the value of assets or by suppressing the liabilities; and it also denotes an absence of secret reserves, i.e. an attempt to show the position of the concern as worse than it is, either by showing the assets at a value much less than their true value or by inflating the liabilities of the company.

From the positive point of view, the concept of "true and fair" implies that the balance sheet and the profit and loss account should be drawn up in conformity with accepted standards of accounting principles, consistently applied from year to year. This would mean a proper distinction between Fixed and Current Assets; capital expenditure and revenue expenditure; capital profit and revenue profit; and a correct application of accounting principles of valuation of current assets and proper principles of depreciation in regard to fixed assets. It implies the inclusion of all expenses and income relating to the year for which the profit and loss account is prepared. The auditor of the company must therefore take care to see that the "assets", "liabilities", "revenue" and "expenses" are so ascertained as to reflect the true state of affairs of the company.

The annual accounts should disclose all material facts and all qualifications thereto which, if not disclosed, will prevent the disclosure of a true and fair view. The auditor must take care to see that the accounts are true and fair not only in the sense of what they disclose but also in the sense of what they conceal or omit. It is possible that every word and every figure may be correctly stated but the accounts as a whole may not be true and fair not because of what they state but because of what they do *NOT* state or because of what they imply. To ensure this, the auditor must comply with the requirements as to disclosure contained in Schedule VI and must also see that in respect of matters not specifically referred to, the best current accounting practice is adopted. The standard of presentation of information must be the one set by the current business practice of honest men in relation to company's accounts.

The disclosure of a fair view would also require that any unusual, exceptional or non-recurring items of income or expenditure; profits or losses; must be disclosed separately so as to

distinguish between the normal and abnormal occurrences affecting the trading and financial position of the company.

To ensure that the annual accounts disclose a true and fair view of the financial position important provisions are made in the Companies Act, 1956. Firstly, Section 209 provides that the books of account should be so kept as to give a true and fair view of the state of the affairs of the company and *to explain its transactions.* This provision is significant in as much as it is not possible to prepare financial statements disclosing true and fair view on the basis of the books of accounts which themselves do not give a true and fair view of the state of affairs or the transactions of the company.

Secondly, Schedule VI, which contains requirements in regard to the annual accounts, gives in Part III, the definition of the terms, "liability," "provision," "reserve" and "capital reserve." The precise definition of these terms should go a long way in ensuring that the accounts present a clear and unambiguous picture. The requirements as to disclosure, under Schedule VI, are sufficient to give to the shareholders and other persons interested, such complete and detailed information as will enable them, to judge the financial position of the company. It appears that the only danger lies in the disclosure of so much information that the layman is confused and thus the very purpose of the disclosure defeated.

§ 4. Form and Contents of Accounts

Section 211 provides that every balance sheet of a company shall give a true and fair view of the state of affairs of the company as at the end of the financial year and shall, subject to the provisions of the said section, be in the form set out in Part I of Schedule VI, or as near thereto as circumstances admit or in such other form as may be approved by the Central Government either generally or in any particular case. In preparing the balance sheet due regard shall be had, as far as may be, to the general instructions for preparation of balance sheet under the heading "Notes" at the end of that Part.

The profit and loss account of a company shall give a true and fair view of the profit or loss of the company for the financial year and shall, subject as aforesaid, comply with the requirements of Part II of Schedule VI, so far as they are applicable

thereto.

It is further provided that nothing contained in the above provisions shall apply to any insurance or banking company or any company engaged in the generation or supply of electricity or to any other class of company for which a form of balance sheet or profit and loss account, as the case may be has been specified in or under the Act governing such class of company.

However, if in the opinion of the Central Government it is necessary to grant exemption in the public interest, it may, by notification in the Official Gazette, exempt any class of companies from compliance with any of the requirements of Schedule VI, either unconditionally or subject to such conditions as may be specified in the Notification.

The Central Government is also empowered, either on the application of or with the consent of, the Board of directors of the company, by order, to modify in relation to that company any of the requirements of this Act as to matters to be stated in the company's balance sheet or profit and loss account, for the purpose of adapting them to the circumstances of the company.

Section 211(5) provides that:

The balance sheet and the profit and loss acount of a company shall not be treated as not disclosing a true and fair view of the state of affairs of the company, merely by reason of the fact that they do not disclose—

(*i*) in the case of an insurance company, any matters which are not required to be disclosed by the Insurance Act, 1938;

(*ii*) in the case of a banking company, any matters which are not required to be disclosed by the Banking Companies Act, 1949;

(*iii*) in the case of a company engaged in the generation or supply of electricity, any matters which are not required to be disclosed by both the Indian Electricity Act, 1910, and the Electricity (Supply) Act, 1948;

(*iv*) in the case of a company governed by any other special Act for the time being in force, any matters which are not required to be disclosed by that special Act; or

(*v*) in the case of any company, any matters which are not required to be disclosed by virtue of the provisions contained in Schedule VI or by virtue of a notification issued under sub-section (3) or an order issued under sub-section (4).

For the purposes of Section 211, any reference to a balance

sheet or profit and loss account shall include any notes thereon or documents annexed thereto, giving information required by the Act, and allowed by the Act to be given in the form of such notes or documents, except where the context otherwise requires.

For non-compliance with the above provisions the penalty is imprisonment upto six months or a fine upto rupees one thousand or both.

Section 222 provides that:

References in this Act to documents annexed or required to be annexed to a company's accounts or any of them shall not include the Board's report, the auditors' report or any document attached or required to be attached to those accounts:

Provided that any information which is required by this Act to be given in the accounts, and is allowed by it to be given in a statement annexed to the accounts, may be given in the Board's report instead of in the accounts; and if any such information is so given, the report shall be annexed to the accounts and this Act shall apply in relation thereto accordingly, except that the auditors shall report thereon only in so far as if gives the said information.

Section 216 provides that:

The profit and loss account shall be annexed to the balance sheet and the auditors' report (including the auditors' separate, special or supplementary report, if any) shall be attached thereto.

Schedule VI, which deals with the form of the balance sheet in Part I, with requirements as to the profit and loss account in Part II and with interpretation in Part III as on p. 330.

PART II.—REQUIREMENTS AS TO PROFIT AND LOSS ACCOUNT

1. The provision of this Part shall apply to the income and expenditure account referred to in sub-section (2) of section 210 of the Act, in like manner as they apply to a profit and loss account, but subject to the modification of references as specified in that sub-section.

2. The profit and loss account—

(*a*) shall be so made out as clearly to disclose the result of the working of the company during the period covered by the account; and

(*b*) shall disclose every material feature, including credits or receipts and debits or expenses in respect of non-recurring transactions or transactions of an exceptional nature.

SCHEDULE VI

[*See* section 211.]

PART I—FORM OF BALANCE SHEET

Balance-Sheet of ..... (Here enter the name of the company)

As at ..... (Here enter the date as at which the balance-sheet is made out)

Instructions in accordance with which liabilities should be made out	LIABILITIES		ASSETS		Instructions in accordance with which assets should be made out
	Figures for the previous year	Figures for the current year	Figures for the previous year	Figures for the current year	
	Rs. (*b*)	Rs. (*b*)	Rs. (*b*)	Rs. (*b*)	
*Terms of redemption or conversion (if any) of any redeemable preference capital to be stated, together with earliest date of redemption or conversion.	*SHARE CAPITAL:		*FIXED ASSETS:		*Under each head the original cost, and the additions thereto and deductions therefrom during the year, and the total depreciation written off or provided up to the end of the year to be stated.
	Authorised .... shares. of Rs. ..... each. †Issued (distinguishing between the various classes of capital and stating the particulars		Distinguishing as far as possible between expenditure upon (*a*) good-will, (*b*) land, (*c*) buildings, (*d*) leaseholds, (*e*) railway		

Particulars of any option on unissued share capital to be specified. ‡Particulars of the different classes of preference shares to be given. *Specify the source from which bonus shares are issued, *e.g.*, capitalisation	specified below, in respect of each class).... shares of Rs.....each. †Subscribed (distinguishing between the various classes of capital and stating the particulars specified below, in respect of each class.) (*c*) ..... shares of Rs. ..... each. Rs. ..... called up. Of the above shares,... shares are allotted as fully paid up pursuant to a contract without payments being received in cash. Of the above shares, ..shares are allotted as	sidings, (*f*) plant and machinery, (*g*) furniture and fittings, (*h*) development of property, (*i*) patents, trade marks and designs, (*j*) live-stock and (*k*) vehicles, etc.	In every case where the original cost cannot be ascertained, without unreasonable expense or delay, the valuation shown by the books shall be given. For the purposes of this paragraph, such valuation shall be the net amount at which an asset stood in the company's books at the commencement of this Act after deduction of the amounts previously provided or written off for depreciation or diminution in value, and where any such asset is sold, the amount of sales proceeds shall be shown as deduction.

Instructions in accordance with which liabilities should be made out	LIABILITIES		ASSETS		Instructions in accordance with which assets should be made out
	Figures for the previous year	Figures for the current year	Figures for the previous year	Figures for the current year	
	Rs. (*b*)	Rs. (*b*)	Rs. (*b*)	Rs. (*b*)	
of profits or Reserves or from Share Premium Account.	fully paid up by way of bonus shares*. *Less*: Calls unpaid. (*i*) By managing agent or secretaries and treasurers and where the managing agent or secretaries and treasurers are a firm, by the partners thereof, and where the managing agent or secretaries and treasurers are a private company, by the directors or members of that company.				Where sums have been written off on a reduction of capital or a revaluation of assets, every balance-sheet, (after the first balance-sheet) subsequent to the reduction or revaluation shall show the reduced figures and with the date of the reduction in place of the original cost. Each balance-sheet for the first five years subsequent to

	(*ii*) By directors.		the date of the reduction, shall show also the amount of the reduction made.
††Any capital profit on re-issue of forfeited shares should be transferred to Capital Reserve.	(*iii*) By others. *Add*: Forfeited shares (amount originally paid up).		Similarly, where sums have been added by writing up the assets, every balance-sheet subsequent to such writing up shall show the increased figures with the date of the increase in place of the original cost. Each balance-sheet for the first five years subsequent to the date of writing up shall also show the amount of increase made.
	***RESERVES AND SURPLUS:**	**INVESTMENTS:**	
*Additions and deductions since last balance-sheet to be shown, under each of the specified heads. The word "fund" in relation to any "Reserve" should be used only where such Reserve is specifically represented by earmarked investments.	[(1) Capital Reserves. (2) Capital Redemption Reserve. (3) Share Premium Account (*cc*). (4) Other Reserves specifying the nature of each Re-	Showing nature of investments and mode of valuation, for example cost or market value and distinguishing between— *(1) Investments in Government or Trust Securities.	*Aggregate amount of company's quoted investments and also the market value thereof shall be shown. Aggregate amount of company's unquoted investments shall also be shown.

Instructions in accordance with which liabilities should be made out	LIABILITIES		ASSETS		Instructions in accordance with which assets should be made out
	Figures for the previous year	Figures for the current year	Figures for the previous year	Figures for the current year	
	Rs. (*b*)	Rs. (*b*)	Rs. (*b*)	Rs. (*b*)	
	serve and the amount in respect thereof.		*(2) Investments in shares, debentures or bonds (showing separately shares, fully paid up and partly paid up and also distinguishing the different classes of shares and showing also in similar details investments in shares, debentures or bonds of subsidiary companies.		
	Less: Debit balance in profit and loss account (if any) (*h*).				
	(5) Surplus, *i.e.*, balance in profit and loss account after providing for proposed allocations, namely:		Immovable properties.		
	Dividend, Bonus or Reserves.				

(6) Proposed additions to Reserves.

(7) Sinking Funds.

SECURED LOANS:

*(1) Debentures†

*(2) Loans and advances from Banks.

*(3) Loans and Advances from subsidiaries.

*(4) Other Loans and Advances.

CURRENT ASSETS, LOANS AND ADVANCES:

(A) CURRENT ASSETS

(1) Interest accrued on Investments.

††(2) Stores and spare parts.

(3) Loose Tools.

††(4) Stock-in-trade.

**(5) Works in Progress.

†(6) Sundry debtors.
(*a*) Debts outstanding for a period exceeding six months.

*Loans from Directors, the Managing Agents, Secretaries and Treasurers, Manager should be shown separately.

Interest accrued and due on Secured Loans should be included under the appropriate sub-heads under the head "SECURED LOANS."

*The nature of the security to be specified in each case.

Where loans have been guaranteed by managing agents, secretaries and treasurers, managers and/or directors, a mention thereof shall also be made and also the aggregate amount of such loans

††Mode of valuation of stock shall be stated and the amount in respect of raw materials shall also be stated separately where practicable.

**Mode of valuation of works in progress shall be stated.

†In regard to Sundry Debtors particulars to be given separately of—(*a*) debts considered good and in respect of which the company is fully secured; and (*b*) debts considered good for which the company holds no security other than the debtor's personal security; and (*c*) debts considered doubtful or bad.

Instructions in accordance with which liabilities should be made out	LIABILITIES		ASSETS		Instructions in accordance with which assets should be made out
	Figures for the previous year	Figures for the current year	Figures for the previous year	Figures for the current year	
	Rs.	Rs.	Rs.	Rs.	
	(*b*)	(*b*)	(*b*)	(*b*)	
under each head. †Terms of redemption or conversion (if any) of debentures issued to be stated together with earliest date of redemption or conversion.			(*b*) Other debts. *Less*: Provision (7A) Cash balance on hand. (7B) Bank balances— (*a*) with Scheduled Banks; and (*b*) with others.		Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member to be separately stated. Debts due from other companies under the same management within the meaning of sub-section (IB) of Section 370, to be disclosed with the names of the companies;

			The maximum amount due by directors or other officers of the company at any time during the year to be shown by way of a note.
			The Provision to be shown under this head should not exceed the amount of debts stated to be considered doubtful or bad and any surplus of such Provision, if already created, should be shown at every closing under "Reserves and Surplus" (in the Liabilities side) under a separate sub-head "Reserve for Doubtful or Bad Debts".
			"†In regard to bank balances, particulars to be given separately of—
			(*a*) the balances lying with Scheduled Banks on current accounts, call accounts and deposit accounts;

Instructions in accordance with which liabilities should be made out	LIABILITIES		ASSETS		Instructions in accordance with which assets should be made out
	Figures for the previous year	Figures for the current year	Figures for the previous year	Figures for the current year	
	Rs. (*b*)	Rs. (*b*)	Rs. (*b*)	Rs. (*b*)	(*b*) the names of the bankers other than Scheduled Banks and the balance lying with each such banker on current accounts, call accounts and deposit accounts and the maximum amount outstanding at any time during the year from each such banker; and (*c*) the nature of the interest, if any of any director or his relative or the managing agent secretaries and treasurers of any associate of the

			latter in each of the bankers (other than Scheduled Banks) referred to in (*b*) above."
† Loans from Directors, the Managing Agents, Secretaries and Treasurers, Manager should be shown separately.	UNSECURED LOANS: (1) Fixed Deposits. †(2) Loans and Advances from subsidiaries.		
Interest accrued and due on Unsecured Loans should be included under the appropriate sub-heads under the head "UNSECURED LOANS".	†*(3) Short Term Loans and Advances: (*a*) From Banks. (*b*) From others.		
†Where loans have been guaranteed by managing agents, secretaries and treasurers, managers, and/or directors, a mention thereof shall also be made and also the aggregate amount of such loans under each head.	†(4) Other Loans and Advances: (*a*) From Banks. (*b*) From others.		

Instructions in accordance with which liabilities should be made out	LIABILITIES		ASSETS		Instructions in accordance with which assets should be made out
	Figures for the previous year	Figures for the current year	Figures for the previous year	Figures for the current year	
	Rs. (*b*)	Rs. (*b*)	Rs. (*b*)	Rs. (*b*)	
*See note (*d*) at foot of Form.	CURRENT LIABILITIES AND PROVISIONS:				
	A. CURRENT LIABILITIES.		†(B) LOANS AND ADVANCES.		
	(1) Acceptances. (2) Sundry Creditors. (3) Subsidiary Companies. (4) Advance payments and unexpired discounts for the portion for which value has still to be given, *e.g.*, in the case of the following classes of companies:—		(8) Advances and Loans to subsidiaries. (9) Bills of Exchange. (10) Advances recoverable in cash or in kind or for value to be received, *e.g.*, Rates, Taxes, Insurance, etc.		†The above instructions regarding "Sundry Debtors" apply to "Loans and Advances" also.

Newspaper, Fire Insurance, Theatres, Clubs, Banking, Steamship Companies, etc.	(11) Balances on current account with Managing Agents or Secretaries and Treasurers. (12) Balances with Customs, Port Trust, etc. (where payable on demand).
(5) Unclaimed Dividends. (6) Other Liabilities (if any). (7) Interest accrued but not due on loans.	
B. PROVISIONS.	
[(8) Provision for Taxation. (9) Proposed Dividends. (10) For contingencies.	
(11) For Provident Fund scheme.	

[Instructions in accordance with which liabilities should be made out	LIABILITIES		ASSETS		Instructions in accordance with which assets should be made out
	Figures for the previous year	Figures for the current year	Figures for the previous year	Figures for the current year	
	Rs. (*b*)	Rs. (*b*)	Rs. (*b*)	Rs. (*b*)	
	(12) For insurance, pension and similar staff benefit schemes.				
	(13) Other provisions.]				
††The period for which the dividends are in arrear or if there is more than one class of shares, the dividends on each such class are in arrear, shall be stated.	[A foot-note to the balance-sheet may be added to show separately:—				
	(1) Claims against the company not acknowledged as debts.				
	(2) Uncalled liability on shares partly paid.				

The amount shall be stated before deduction of Income-tax, except that in the case of tax-free dividends the amount shall be shown free of income-tax and the fact that it is so shown shall be stated.

†The amount of any guarantees given by the company on behalf of directors or other officers of the company shall be stated and where practicable, the general nature and amount of each such contingent liability, if material, shall also be specified.

††(3) Arrears of fixed cumulative dividends.

(4) Estimated amount of contracts remaining to be executed on capital account and not provided for.

†(5) Other money for which the company is contingently liable.]

MISCELLANEOUS EXPENDITURE (to the extent not written off or adjusted):

(1) Preliminary expenses.

(2) Expenses including commission or brokerage on underwriting or subscription of shares or debentures.

(3) Discount allowed on the issue of shares or debentures.

Instructions in accordance with which liabilities should be made out	LIABILITIES		ASSETS		Instructions in accordance with which assets should be made out
	Figures for the previous year	Figures for the current year	Figures for the previous year	Figures for the current year	
	Rs. (*b*)	Rs. (*b*)	Rs. (*b*)	Rs. (*b*)	
			(4) Interest paid out of capital during construction (also stating the rate of interest).		
			(5) Development expenditure not adjusted.		†Show here the debit balance of profit and loss account carried forward after deduction of the uncommitted reserves, if any.
			(6) Other items (specifying nature).		
			†PROFIT AND LOSS ACCOUNT.		

NOTES

General instructions for preparation of balance-sheet.—(*a*) The information required to be given under any of the items or sub-items in this Form, if it cannot be conveniently included in the balance-sheet itself, shall be furnished in a separate Schedule or Schedules to be annexed to and to form part of the balance-sheet. This is recommended when items are numerous.

(*b*) Naye Paise can also be given in addition to Rupees, if desired.

(*c*) In the case of subsidiary companies the number of shares held by the holding company as well as by the ultimate holding company and its subsidiaries must be separately stated.

The auditor is not required to certify the correctness of such share-holdings as certified by the management.

(*cc*) The item "Share Premium Account" shall include details of its utilisation in the manner provided in section 78 in the year of utilisation.

(*d*) Short Term Loans will include those which are due for not more than one year as at the date of the balance-sheet.

(*e*) Depreciation written off or provided shall be allocated under the different asset heads and deducted in arriving at the value of Fixed Assets.

(*f*) Dividends declared by subsidiary companies after the date of the balance-sheet should not be included unless they are in respect of period which closed on or before the date of the balance-sheet.

(*g*) Any reference to benefits expected from contracts to the extent not executed shall not be made in the balance-sheet but shall be made in the Board's report.

(*h*) The debit balance in the Profit and Loss Account shall be shown as a deduction from the uncommitted reserves, if any.

(*i*) As regards Loans and Advances, amounts due by the Managing Agents or Secretaries and Treasurers, either severally or jointly with any other persons, to be separately stated; the amounts due from other companies under the same management within the meaning of sub-section (IB) of Section 370 should also be given with the names of the companies; the maximum amount due from every one of these at any time during the year must be shown.

(*j*) Particulars of any redeemed debentures which the company has power to issue should be given.

(*k*) Where any of the company's debentures are held by a nominee or a trustee for the company, the nominal amount of the debentures and the amount at which they are stated in the books of the company shall be stated.

(*l*) A statement of investments (whether shown under "Investments" or under "Current Assets" as stock-in-trade) separately classifying trade investments and other investments should be annexed to the balance-sheet showing the names of the bodies corporate, indicating separately the names of the bodies corporate in the same group (with the name of the managing agent or secretaries and treasurers, if any, of every body corporate) in whose shares or debentures investments have been made (including all investments whether existing or not, made subsequent to the date as at which the previous balance-sheet was made out) and the nature and extent of the investments so made in each such body corporate; provided that in the case of an investment company, that is to say, a company whose principal business is the acquisition of shares, stock, debentures or other securities, it shall be sufficient if the statement shows only the investments existing on the date as at which the balance-sheet has been made out; provided further that it shall not be necessary to give any particulars in respect of investments made by a managing agency or secretaries and treasurers company in the managed companies' shares or debentures.

A "Trade Investment" means an investment by a company in the shares or debentures of another company, not being its subsidiary, for the purpose of promoting the trade or business of the first company.

(*m*) If, in the opinion of the Board, any of the current assets, loans and advances have not a value on realisation in the ordinary course of business at least equal to the amount at which they are stated, the fact that the Board is of that opinion shall be stated.

(*n*) Except in the case of the first balance-sheet laid before the company after the commencement of the Act, the corresponding amounts for the immediately preceding financial year for all items shown in the balance-sheet shall be also given in the balance-sheet. The requirement in this behalf shall, in the case of companies preparing quarterly or half-yearly accounts, etc., relate to the balance-sheet for the corresponding date in the previous year.

(*o*) The amounts to be shown under Sundry Debtors shall include the amounts due in respect of goods sold or services rendered or in respect of other contractual obligations but shall not include the amounts which are in the nature of loans or advances.

(*p*) Current accounts with Directors, Managing Agents, Secretaries and Treasurers and Manager, whether they are in credit or debit, shall be shown separately.

3. The profit and loss account shall set out the various items relating to the income and expenditure of the company arranged under the most convenient heads; and in particular, shall disclose the following information in respect of the period covered by the account:—

(*i*) (*a*) The turnover, that is, the aggregate amount for which sales are effected by the company.

(*b*) Commission paid to sole selling agents within the meaning of section 294 of the Act.

(*c*) Commission paid to other selling agents.

(*d*) Brokerage and discount on sales, other than the usual trade discount.

(*ii*) (a) In the case of manufacturing concerns, the purchases of raw material, and the opening and the closing stocks of the goods produced.

(*b*) In the case of trading concerns, the purchases made, and the opening and the closing stocks.

(*c*) In the case of concerns rendering or supplying services, the gross income derived from services rendered or supplied.

(*d*) In the case of a concern which falls under more than one of the categories mentioned under clauses (*a*), (*b*) and (*c*) above, it shall be sufficient compliance of the requirements herein if the total amounts are shown in respect of the opening and closing stocks, purchases and sales and the gross income from services rendered is shown.

(*e*) In the case of other concerns, the gross income derived under the different heads.

(*iii*) In the case of all concerns having works in progress, the amounts for which such works have been completed at the commencement and at the end of the accounting period.

(*iv*) The amount provided for depreciation, renewals or diminution in value of fixed assets.

If such provision is not made by means of a depreciation charge, the method adopted for making such provision.

If no provision is made for depreciation, the fact that no provision has been made shall be stated and the quantum of arrears of depreciation computed in accordance with section 205(2) of the Act shall be disclosed by way of a note.

(*v*) The amount of interest on the company's debentures and other fixed loans, that is to say, loans for fixed periods, stating separately the amount of interest, if any, paid or payable to the managing director, the managing agent, the secretaries and treasurers and the manager, if any.

(*vi*) The amount of charge for Indian income-tax and other Indian taxation on profits, including, where practicable, with Indian income-tax any taxation imposed elsewhere to the extent of the relief, if any, from Indian income-tax and distinguishing, where practicable, between income-tax and other taxation.

(*vii*) The amounts reserved for—
  (*a*) repayment of share capital; and
  (*b*) repayment of loans.

(*viii*) (*a*) The aggregate, if material, of any amounts set aside or proposed to be set aside, to reserves, but not including provisions made to meet any specific liability, contingency or commitment known to exist at the date as at which the balance-sheet is made up.

(*b*) The aggregate, if material, of any amounts withdrawn from such reserves.

(*ix*) (*a*) The aggregate, if material, of the amounts set aside to provisions made for meeting specific liabilities, contingencies or commitments.

(*b*) The aggregate, if material, of the amounts withdrawn from such provisions, as no longer required.

(*x*) Expenditure incurred on each of the following items, separately for each item:—
  (*a*) Consumption of stores and spare parts.
  (*b*) Power and fuel.
  (*c*) Rent.
  (*d*) Repairs to buildings.
  (*e*) Repairs to machinery.
  (*f*) (1) Salaries, wages and bonus.
    (2) Contribution to provident and other funds.
    (3) Workmen and staff welfare expenses to the extent not adjusted from any previous provision or reserve.

  Note.—Information in respect of this item should also be given in the balance-sheet under the relevant provision or reserve account.

  (*g*) Insurance.
  (*h*) Rates and taxes, excluding taxes on income.
  (*i*) Miscellaneous expenses.

(*xi*) (*a*) The amount of income from investments, distinguishing between trade investments and other investments.

(*b*) Other income by way of interest, specifying the nature of the income.

(*c*) The amount of income-tax deducted if the gross income is stated under sub-paragraphs (*a*) and (*b*) above.

(*xii*) (*a*) Profits or losses on investments to the extent not adjusted from any previous provision or reserve.

Note.—Information in respect of this item should also be given in the balance-sheet under the relevant provision or reserve account.

(*b*) Profits or losses in respect of transactions of a kind, not usually undertaken by the company or undertaken in circumstances of an exceptional or non-recurring nature, if material in amount.

(*c*) Miscellaneous income.

(*xiii*) (*a*) Dividends from subsidiary companies.

(*b*) Provisions for losses of subsidiary companies.

(*xiv*) The aggregate amount of the dividends paid and proposed, and stating whether such amounts are subject to deduction of income-tax or not.

(*xv*) Amount, if material, by which any items shown in the profit and loss account are affected by any change in the basis of accounting.

4. The profit and loss account shall also contain or give by way of a note detailed information, showing separately the following payments provided or made during the financial year to the directors (including managing directors), the managing agents, secretaries and treasurers or manager, if any, by the company, the subsidiaries of the company and any other person:—

(*i*) managerial remuneration under section 198 of the Act paid or payable during the financial year to the directors (including managing directors), the managing agent, secretaries and treasurers or manager, if any;

(*ii*) expenses reimbursed to the managing agent under section 354;

(*iii*) commission or other remuneration payable separately to a managing agent or his associate under sections 356, 357 and 358;

(*iv*) commission received or receivable under section 359 of the Act by the managing agent or his associate as selling or buying agent of other concerns in respect of contracts entered into by such concerns with the company;

(*v*) the money value of the contracts for the sale or purchase of goods and materials or supply of services, entered into by the company with the managing agent or his associate under section 360 during the financial year;

(*vi*) other allowances and commission including guarantee commission (details to be given);

(*vii*) any other perquisites or benefits in cash or in kind (stating approximate money value where practicable);

(*viii*) pensions, etc.,—

(*a*) pensions,

(*b*) gratuities,

(*c*) payments from provident funds, in excess of own subscriptions and interest thereon.

(*d*) compensation for loss of office,

(*e*) consideration in connection with retirement from office.

4A. The profit and loss account shall contain or give by way of a note a statement showing the computation of net profits in accordance with section 349 of the Act with relevant details of the calculation of the commissions payable by way percentage of such profits to the directors

(including managing directors), the managing agents, secretaries and treasurers or manager (if any).

4B. The profit and loss account shall further contain or give by way of a note detailed information in regard to amounts paid to the auditor, whether as fees, expenses, or otherwise for services rendered—

(*a*) as auditor; and

(*b*) in any other capacity.

5. The Central Government may direct that a company shall not be obliged to show the amount set aside to provisions other than those relating to depreciation, renewal or diminution in value of assets, if the Central Government is satisfied that the information should not be disclosed in the public interest and would prejudice the company, but subject to the condition that in any heading stating an amount arrived at after taking into account the amount set aside as such, the provision shall be so framed or marked as to indicate that fact.

6. (1) Except in the case of the first profit and loss account laid before the company after the commencement of the Act, the corresponding amounts for the immediately preceding financial year for all items shown in the profit and loss account shall also be given in the profit and loss account.

(2) The requirement in sub-clause (1) shall, in the case of companies preparing quarterly or half-yearly accounts, relate to the profit and loss account for the period which ended on the corresponding date of the previous year.

PART III.—INTERPRETATION

7. (1) For the purposes of Parts I and II of this Schedule, unless the context otherwise requires,—

(*a*) the expression "provision" shall, subject to sub-clause (2) of this clause, mean any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, or retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy;

(*b*) the expression "reserve" shall not, subject as aforesaid, include any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any known liability;

(*c*) the expression "capital reserve" shall not include any amount regarded as free for distribution through the profit and loss account; and the expression "revenue reserve" shall mean any reserve other than a capital reserve;

and in this sub-clause the expression "liability" shall include all liabilities in respect of expenditure contracted for and all disputed or contingent liabilities.

(2) Where—

(*a*) any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, not being an amount written off in relation to fixed assets before the commencement of this Act; or

(*b*) any amount retained by way of providing for any known liability;

is in excess of the amount which in the opinion of the directors is reasonably necessary for the purpose, the excess shall be treated for the purposes of this Schedule as a reserve and not as a provision.

8. For the purposes aforesaid, the expression "quoted investment" means an investment as respects which there has been granted a quotation or permission to deal on a recognised stock exchange, and the expression "unquoted investment" shall be construed accordingly.

(A) INTERPRETATION

The terms "provision", "reserve", "revenue reserve", "capital reserve" and "liability" are defined by Part III, of Schedule VI.

1. PROVISION

In relation to assets, "provision" means any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets.

In relation to liabilities, "provision" means any amount retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy. Where such amount can be determined with substantial accuracy it must be treated as a "liability."

Where any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, or any amount retained by way of providing for any known liability, is in excess of that which in the opinion of the directors is reasonably necessary for the purpose, the excess must be treated in the accounts as a reserve and not as a provision. This does not apply, however, to amounts *written off* fixed assets prior to 1st April, 1956, although, from a literal interpretation of the relevant provision, it would appear to apply to amounts *retained* prior to that date but not written off the book value of an asset, e.g., to amounts credited to a depreciation fund account.

2. RESERVE

The term "reserve" is defined in the negative, as an amount set aside which is not a provision. The reserve may be either a "capital reserve" or "revenue reserve."

Where additions to or withdrawals from reserves and provisions have been made during the year and such transfers affect the profit and loss account, the amounts involved, if material, must be shown separately in that account or by way of a note. Where, however, the additions or withdrawals are capital transactions, e.g., a transfer to capital reserve of a capital profit, such transactions should either appear on the face of the balance sheet or in a statement or report annexed thereto. The source from which the increase has been derived or the manner in which the decrease has been applied must be shown clearly.

3. REVENUE RESERVE

Revenue reserve means any reserve other than a capital reserve. The term "capital reserve" is negatively defined and therefore it follows that a revenue reserve is one which is available for distribution through the profit and loss account.

4. CAPITAL RESERVE

It will be observed that Part III, Schedule VI does not really define the term capital reserve, but states that it shall not include any amount regarded as free for distribution through the profit and loss account. The term should be used to describe:—

(*i*) reserves which cannot be legally distributed, e.g., share premiums, a capital redemption reserve account, etc., and

(*ii*) reserves which because of their origin or the purpose for which they are retained, are regarded by the directors as not being free for distribution through the profit and loss account, e.g., a sum received as compensation for damage to goodwill, a profit made on the sale of a fixed asset, to the extent that such profit is not due to past excessive provision for depreciation.

5 LIABILITY

The term "liability" includes all liabilities in respect of expenditure contracted for and all disputed or contingent liabilities. It should be noted that if such amount can be determined with substantial accuracy, it must be termed as a "liability" and if it cannot be so determined, it should be treated as a "provision."

6. QUOTED INVESTMENTS

"Quoted investment" is defined as an investment in respect of which there has been granted a quotation or permission to deal on a recognised stock exchange. Other investments should be treated as unquoted investments. This definition is relevant for the purpose of classifying the "investments" which are quoted and those which are not quoted. Under the head "investments", it is necessary to give the market value of quoted investments. The aggregate amounts of quoted and unquoted investments are required to be shown separately.

(B) FORM OF BALANCE SHEET

Part I, Schedule VI to the Companies Act, 1956, prescribes the form of balance sheet and the requirements relating thereto. It should be noted that in addition to the requirements of the body of the Form which sets out instructions relating to each item of the balance sheet, the requirements in the Notes at the end of the Form and the requirements of the Act, wherever applicable, should be complied with.

The information required to be given under any of the items or sub-items in the balance sheet should be furnished in a separate schedule or schedules to be annexed to and to form part of the balance sheet, if such information cannot be conveniently included in the balance sheet itself. This procedure is recommended when the items to be dealt with are numerous [Note (a)].

The general practice is to state the figures rounded off correct to a rupee. Note (b) provides that Naye Paise can also be given in addition to rupees, if so desired.

Note (n) requires that comparative figures should be given.

The comparative figures should relate to the *corresponding period* —the previous year, half year or quarter as the case may be. The comparative figures must be compiled on the same basis as the figures of the current year, on the principle that only like can be compared with like. Wherever the comparative figures are re-cast or re-grouped to make them comparable it is recommended that a note should be put under the balance sheet to that effect.

In the prescribed Form, the main items in the balance sheet appear as follows:—

Liabilities:	**Assets:**
SHARE CAPITAL.	FIXED ASSETS.
RESERVES & SURPLUS.	INVESTMENTS.
SECURED LOANS.	CURRENT ASSETS,
UNSECURED LOANS.	LOANS AND ADVANCES:
CURRENT LIABILITIES AND PROVISIONS:	(A) CURRENT ASSETS,
(A) CURRENT LIABILITIES.	(B) LOANS AND ADVANCES.
(B) PROVISIONS.	MISCELLANEOUS EXPENDITURE.

FOOT NOTE in respect of CONTINGENT LIABILITIES.

The requirements in respect of each item are discussed hereunder:

I. SHARE CAPITAL.

The Share Capital should be classified into:

(*a*) Authorised Capital.
(*b*) Issued Capital.
(*c*) Subscribed Capital.

Under "Authorised Capital," the number of shares and the face value of each share should be stated.

Under "Issued Capital," the various classes of shares should be distinguished and the particulars of the numbers of shares and the face value of shares for each class should be stated. The particulars of the different classes of preference shares should also be given.

Under "Subscribed Capital," the following particulars should be given:

(*i*) The various classes of shares should be distinguished and particulars of the different classes of preference shares should be stated.
(*ii*) Number of shares.
(*iii*) Face value of shares.
(*iv*) Amount called up.

Note (c) requires that in the balance sheets of subsidiary companies the number of shares held by the holding company as well as by the ultimate holding company and its subsidiaries must be separately stated. However, the auditor is not required to certify the correctness of such shareholdings as certified by the management.

The number of shares allotted as fully paid up pursuant to a contract without payments being received in cash should be shown separately. Even in respect of such shares a separate mention must be made of the shares which are allotted as fully paid up by way of *bonus* shares. In case of bonus shares, the source from which such shares are issued, e.g., capitalisation of profits or reserves or from Share Premium Account, should be specified.

The unpaid calls should be deducted from the Subscribed Capital and should be analysed as under:

(*i*) Due by managing agent or secretaries and treasurers; if they are a firm by every partner thereof; if they are a private company by the directors or members of that company.
(*ii*) Due by directors.
(*iii*) Due by others.

The amount originally paid up on the forfeited shares should be added to the Subscribed Capital. Any capital profit on re-issue of forfeited shares should be transferred to a Capital Reserve.

Under the item "Share Capital", it is necessary to disclose:

(*i*) In respect of Redeemable Preference Shares, the terms of redemption or conversion together with the earliest date of redemption or conversion, and
(*ii*) the particulars of any option on unissued share capital.

It should be noted that Share Premium Account should not be shown under "Share Capital," as it is required to be shown under "Reserves and Surplus".

II. RESERVES AND SURPLUS.

This item should be classified as under:

1. Capital Reserves.
2. Capital Redemption Reserve.
3. Share Premium Account.
4. Other Reserves specifying the nature and amount of each Reserve.
5. Surplus.
6. Proposed additions to Reserves.
7. Sinking Funds.

Under each of the above specific heads, the balance as per last balance sheet, additions thereto and deductions therefrom should be stated.

The word "fund" in relation to any "Reserve" should be used only where such Reserve is specifically represented by earmarked investments.

In respect of the Share Premium Account, details of its utilisation in the manner provided in Section 78 should be given in the year of utilisation (Note cc).

In respect of other reserves, the nature and the amount of each reserve should be specified.

Any debit balance in the Profit and Loss Account should be shown as a deduction from the uncommitted reserves, if any Note h).

The expression "uncommitted reserves", would not include reserves set apart for a specific purpose such as reserve for doubtful debts, investments fluctuation reserve, etc.

Under "Surplus" should be shown the balance in the Profit and Loss Account after providing for proposed allocations, namely, Dividend, Bonus or allocations to Reserves.

While classifying the items between Reserves and Provisions regard must be had to the definitions of these items given in Part III, Schedule VI, and accordingly any provision in excess of the amount reasonably necessary should be classified as a reserve.

III. SECURED LOANS.

This item should be classified as follows:

1. Debentures.
2. Loans and Advances from Banks.
3. Loans and Advances from subsidiaries.
4. Other Loans and Advances.

The nature of the security should be specified in each case. The interest *accrued and due* on "Secured Loans" should be included under the appropriate sub-heads under the head "Secured Loans", but the interest *accrued but not due* on secured loans is required to be shown under "Current Liabilities".

The loans from directors, managing agents, secretaries and treasurers and manager should be shown separately. Where loans have been guaranteed by managing agents, secretaries and treasurers, managers and/or directors, a mention thereof should be made and the aggregate amount of such loans under each head should be shown separately.

In respect of debentures, the terms of redemption or conversion and the earliest date of redemption or conversion should be stated. The particulars of any redeemed debentures which the company has power to re-issue should be given.

In case where any of the company's debentures are held by a nominee or a trustee for the company, the nominal amount of the debentures and the amount at which they are stated in the books of the company should be stated. This disclosure may be given under the head "Investments."

IV. UNSECURED LOANS.

This item should be classified as follows:

1. Fixed Deposits.
2. Loans and Advances from subsidiaries.
3. Short Term Loans and Advances:
   (*a*) From Banks.
   (*b*) From Others.
4. Other Loans and Advances:
   (*a*) From Banks.
   (*b*) From Others.

Loans from directors, managing agents, secretaries and treasurers, and managers should be shown separately.

In respect of item Nos. 2, 3 and 4, where loans have been guaranteed by managing agents, secretaries and treasurers, managers and/or directors, a mention thereof should be made and the aggregate amount of such loans under each head should also be disclosed.

The Short Term Loans will include those which are due for not more than one year as at the date of the Balance Sheet.

The interest *accrued and due* on unsecured loans should be shown under the appropriate sub-heads but the *interest accrued but not due* must be shown under "Current Liabilities."

V. CURRENT LIABILITIES AND PROVISIONS.

Current Liabilities and Provisions are required to be grouped separately as under:—

(A) CURRENT LIABILITIES

1. Acceptances.
2. Sundry Creditors.
3. Subsidiary Companies.
4. Advance payments and unexpired discounts for the portion for which value has still to be given, e.g., in the case of the following classes of companies:—
   Newspaper, Fire Insurance, Theatres, Clubs, Banking, Steamship Companies, etc.
5. Unclaimed Dividends.
6. Other Liabilities.
7. Interest accrued but not due on loans.

(B) PROVISIONS

8. Provision for Taxation.
9. Proposed Dividends.
10. For Contingencies.
11. For Provident Fund Scheme.
12. For Insurance, pension and similar staff benefit schemes.
13. Other provisions.

The items should be classified as "Provision" or "Liabilities" having regard to the definitions of these terms in Part III, Schedule VI.

According to Note (p), current accounts with directors, managing agents, secretaries and treasurers and manager, whether they are in credit or debit, should be shown separately.

It should be noted that interest *accrued but not due* on loans, whether secured or unsecured, is required to be shown under "Current Liabilities."

The provision for taxation if in excess of the amount, which in the opinion of the directors, is reasonably necessary for the purpose, should be classified as a "Reserve."

In regard to proposed dividends on Preference Shares, the provisions of the Preference Shares (Regulation of Dividends) Act, 1960, where applicable, should be complied with.

Clause 5 of Part II, Schedule VI, provides as under:—

(The Central Government may direct that a company shall not be obliged to show the amount set aside to provisions other than those relating to depreciation, renewal or diminution in value of assets, if the Central Government is satisfied that the information should not be disclosed in the public interest and would prejudice the company, but subject to the condition that in any heading stating an amount arrived at after taking into account the amount set aside as such, the provision shall be so framed or marked as to indicate that fact.)

VI. CONTINGENT LIABILITIES.

Under the head "Contingent Liabilities," the items should be classified as under:

1. Claims against the company not acknowledged as debts.
2. The uncalled liability on shares partly paid.
3. Arrears of fixed cumulative dividends.
4. Estimated amount of contracts remaining to be executed on capital account and not provided for.
5. Other money for which the company is contingently liable.

In respect of arrears of fixed cumulative dividends, the following details should be given:

(*i*) the period for which the dividends are in arrears showing separately such arrears on each class of shares.

(*ii*) the amount should be stated before deduction of income-tax, but in the case of tax free dividends the amount should be shown free of income-tax and the fact that it is so shown should be stated.

Under sub-head 5, the amount of guarantees given by the company on behalf of directors or other officers of the company should be stated and where practicable, the general nature and the amount of each such contingent liability, if material, should be specified. Examples of other contingent liabilities are:

(*i*) Liability on Bills of Exchange discounted but not maturing on the balance sheet date.

(*ii*) Liability in respect of suits pending in the Court.

(*iii*) Dispute in regard to bonus, etc.

(*iv*) Matters referred to arbitration.

VII. FIXED ASSETS.

The fixed assets should be classified as far as possible as under:—

(*a*) Goodwill.
(*b*) Land.
(*c*) Buildings.
(*d*) Leaseholds.
(*e*) Railway sidings.
(*f*) Plant and Machinery.
(*g*) Furniture and Fittings.
(*h*) Development of Property.
(*i*) Patents, trade-marks and designs.
(*j*) Livestock.
(k) Vehicles.

The items of fixed assets not enumerated above should be shown separately as far as possible. There should be shown under each head the original cost, additions thereto and deductions therefrom during the year.

The total amount of depreciation written off or provided upto the end of the year should be stated. But according to clause 7 of Part III, where in the opinion of the directors, the amount of

depreciation *written off*, before the commencement of the Act, is in excess of the amount reasonably necessary, the excess should be treated as a "Reserve" and not as a "Provision."

In case where the original cost cannot be ascertained without unreasonable expense or delay, the valuation shown by the books should be given. Such valuation should be the net amount at which an asset stood in the company's books at the commencement of the Act, after deduction of the amounts previously provided or written off for depreciation or diminution in value. When any such asset is sold, the amount of sale proceeds should be shown as deduction.

In case, where sums have been written off on a reduction of capital or a revaluation of assets, every balance sheet, (after the first balance sheet) subsequent to the reduction or revaluation should show the reduced figures, with the date of reduction, in place of the original cost. Every balance sheet for five years subsequent to the date of reduction must also show the amount of the reduction made.

Similarly, where the value of assets is written up, every balance sheet subsequent to such writing up must show the increased figures and the date of the increase in place of the original cost. Every balance sheet for the five years subsequent to the date of writing up must also show the amount of increase made.

The amount of depreciation written off or provided should be allocated under the different asset heads and should be deducted in arriving at the value of fixed assets.

VIII. INVESTMENTS.

This item should be classified as under:

1. Investments in Government or Trust securities;
2. Investment in shares, debentures or bonds; and
3. Immovable properties.

Under item (2) above, investments in shares, debentures or bonds of subsidiary companies should be separately stated.

In respect of *all* investments in shares, there should be shown separately, shares, fully paid up and partly paid up and the different classes of shares should be distinguished.

The nature of investments should be disclosed and where the

investments are earmarked, the fund which such investments represent should be stated.

In each case, the mode of valuation, e.g., cost or market value should be stated.

The aggregate amount of a company's quoted investments together with the market value thereof and the aggregate amount of a company's unquoted investments should be shown separately.

The interest accrued on investments should be shown under the heading "current assets" and not under this head.

Section 372 (10) provides that every investing company shall annex to each balance sheet prepared by it after the commencement of the Companies (Amendment) Act, 1960, a statement showing the bodies corporate (indicating separately the bodies corporate in the same group) in the shares of which investments have been made by it (including all investments, whether existing or not, made subsequent to the date as at which the previous balance sheet was made out) and the nature and extent of the investments so made in each body corporate. However, in case of an investing company, it is sufficient if the statement shows only the investments existing as on the date of the balance sheet.

Under Section 372(14), the provisions of Section 372 do not apply:—

(*a*) to any banking or insurance company;
(*b*) to a private company, unless it is a subsidiary of a public company;
(*c*) to any company established with the object of financing, whether by way of making loans or advances to, or subscribing to the capital of, private industrial enterprises in India, in any case where the Central Government has made or agreed to make to the company a special advance for the purpose or has guaranteed or agreed to guarantee the payment of moneys borrowed by the company from any institution outside India;
(*d*) to investments by a holding company in its subsidiary; or
(*e*) to investments by a managing agent or secretaries and treasurers in a company managed by him or them.

It may be noted that note (1) makes a provision for disclosure similar to the one required under Section 372(10) but the said

section does not apply to certain companies. However, note (1) does not contain similar exceptions. Hence, it appears that note (1) will apply to all companies except those mentioned in the note (1) itself.

Note (1) requires that a statement of investments (whether shown under "investments" or under "current assets" as stock-in-trade) separately classifying trade investments and other investments should be annexed to the balance sheet.

A "trade investment" means an investment by a company in the shares or debentures of another company, not being its subsidiary, for the purpose of promoting the trade or business of the first company.

The said statement should show the names of the bodies corporate, indicating separately the names of the bodies corporate in the same group in whose shares or debentures, investments have been made. The nature and extent of the investments so made in each such body corporate should be given.

Such statement should include all investments whether existing or not, made subsequent to the date as at which the previous balance sheet was made out.

In respect of bodies corporate in the same group, the name of the managing agent or secretaries and treasurers if any, should be given.

In case of an investment company, that is to say, a company whose principal business is the acquisition of shares, stock, debentures or other securities, it will be sufficient if the statement shows only the investments existing on the date as at which the balance sheet has been made out.

In respect of investments made by a managing agency company or a company acting as secretaries and treasurers, it is not necessary to give any particulars in respect of investments made in managed companies' shares or debentures.

Where the company's debentures are held by a nominee or trustee for the company, the nominal amount of the debentures and the amount at which they are stated in the books of the company shall be stated. This disclosure will enable a shareholder to ascertain how much profit the company will make if the debentures purchased by the company were to be cancelled.

Section 49 requires that all investments made by a company

on its own behalf should be made and held by it in its own name. This requirement does not apply to a company whose principal business consists of the buying and selling of shares or securities. However, a company may not hold the shares in its own name in two cases:

(1) Where the company has a right to appoint any person or persons, or where any nominee or nominees of the company has or have been appointed, as a director or directors of any other body corporate, the shares in such body corporate, to the extent of qualification shares, may be held jointly in the name of the company and such person or nominee.

(2) A company may hold shares in its subsidiary in the name of a nominee or nominees in so far as it is necessary to enable the subsidiary company to comply with the requirements as to minimum number of members.

The above provisions shall not be deemed to prevent a company—

(*i*) from depositing with the company's bankers any shares or securities for collection of dividend or interest thereon;

(*ii*) from depositing with, or transferring to, or holding in the name of, the State Bank of India or a Scheduled bank, being the bankers of the company, shares or securities, in order to facilitate the transfer thereof, within six months;

(*iii*) from depositing with, or transferring to, any person any shares or securities, by way of security for the repayment of any loan advanced to it or the performance of any obligation undertaken by it.

Except in the above cases, the certificate or letter of allotment relating to the shares or securities in which investments have been made by a company, must be in the custody of such company or with the State Bank of India or a Scheduled bank, being the bankers of the company.

Where the shares or securities in which investments have been made by a company are not held by it in its own name, Section 49(7) requires that the company shall, maintain a register and enter therein—

(*a*) the nature, value and such other particulars as may be necessary fully to identify the shares or securities in question; and

(*b*) the bank or person in whose name or custody the shares or securities are held.

In regard to partly paid shares held by a company, the amount of liability in respect of uncalled capital should be stated by way of a footnote under "contingent liabilities."

Section 372 provides that a company shall not be entitled to subscribe for, or purchase the shares of any other body corporate except to the extent and except in accordance with the restrictions and conditions specified therein.

Under Section 372(2) the Board of directors are entitled to invest in shares of any other body corporate up to ten per cent. of the *subscribed capital* of *such other body corporate* subject to the following limits:

(1) The aggregate of the investments made in all other bodies corporate should not exceed thirty per cent. of the *subscribed capital* of the *investing* company. This restriction does not apply to an investment company.

(2) The aggregate of the investments (in shares and debentures) made in the bodies corporate in the *same group* should not exceed twenty per cent. of the *subscribed capital* of the *investing* company.

For the purposes of computing investments in the same group, shares and debentures both should be taken into account.

For computing the percentages specified above, all investments whether made before or after the commencement of the Companies (Amendment) Act, 1960, should be taken into account.

For making an investment in excess of the percentages specified in Section 372(2), the investment must be sanctioned by a resolution of the company in general meeting, *and* it should be approved by the Central Government.

However the restrictions do not apply to investments up to any amount in right shares offered under Section 81(1)(a). Where at any time the investing company intends to invest in shares other than right shares, for computing the aforesaid percentages, all investments including right shares should be taken into account.

The investments must be sanctioned by the Board of directors by a resolution unanimously passed *at a meeting* of the Board and

after giving notice of the resolution to every director as specified in Section 286.

Under Section 372(6) a company is required to maintain a register of investments in shares and debentures of other companies.

Section 372(14) which specifies the companies to which Section 372 does not apply is dealt with *supra* in this paragraph.

IX. CURRENT ASSETS, LOANS AND ADVANCES.

The items under this head are required to be classified into (A) Current Assets and (B) Loans and Advances.

(A) CURRENT ASSETS:

(1) Interest accrued on Investments.
(2) Stores and spare parts.
(3) Loose Tools.
(4) Stock-in-trade.
(5) Works in Progress.
(6) Sundry debtors:
  (*a*) debts outstanding for a period exceeding six months.
  (*b*) Other debts:
  Less: Provision.

(7A) Cash balance on hand.
(7B) Bank balances—
  (*a*) with Scheduled Banks.
  (*b*) with others.

The current accounts with directors, managing agents, secretaries and treasurers and manager, whether they are in credit or debit should be shown separately.

If, in the opinion of the Board, any of the current assets, loans and advances have not a value on realisation in the ordinary course of business at least equal to the amount at which they are stated, the fact that the Board is of that opinion should be stated. For compliance with this requirement, it will be necessary for the auditor to ascertain the opinion of the Board.

In regard to interest accrued on investments, it should be noted

that dividends declared by the subsidiary companies after the date of the balance sheet should not be included unless they are in respect of period which closed on or before the date of the balance sheet.

In respect of stores and spare parts, stock-in-trade and works-in-progress, the mode of valuation should be stated.

As regards stock-in-trade, the amount in respect of raw materials should be stated separately where practicable.

Note (g) requires that any reference to benefits expected from contracts to the extent that they are not executed should not be made in the balance sheet but should be made in the Board's report.

In regard to loose tools, the mode of valuation is not required to be shown as usually they are re-valued every year.

The amounts to be shown under sundry debtors, according to note (o), should include the amounts due in respect of goods sold or services rendered or in respect of other contractual obligations but shall not include the amounts which are in the nature of loans or advances.

The sundry debtors should be classified as under:

(*a*) according to age;

(*b*) according to security and realisability; and

(*c*) showing separately, debts due by persons connected with the management and others.

According to age, sundry debtors should be classified into:

(*i*) debts outstanding for a period exceeding six months;

(*ii*) other debts.

According to security and realisability, sundry debtors should be classified as under:—

(*i*) debts considered good and in respect of which the company is fully secured;

(*ii*) debts considered good for which the company holds no security other than the debtor's personal security; and

(*iii*) debts considered doubtful or bad.

The debts due from persons connected with the management and others should be classified as under:

(*a*) debts due by directors or other officers of the company or any of them either severally or jointly with any other person;

(*b*) debts due by firms in which any director is a partner;

(*c*) debts due by private companies in which any director is a director or a member;

(*d*) debts due from other companies under the same management (names of the companies should also be disclosed—vide Section 370 (IB)).

By way of a note the maximum amount due by directors or other officers of the company *at any time* during the year should be stated. An officer is defined by Section 2, clause (30).

The provision in respect of bad and doubtful debts should be shown by way of deduction. Such provision should not exceed the amount of debts stated to be considered doubtful or bad and any surplus of such provision, if already created, should be shown under "Reserves and Surplus" in the liabilities side under a separate sub-head "Reserve for Doubtful or Bad Debts."

The cash balance on hand and the bank balances should be shown separately. In respect of bank balances, balances with Scheduled Banks and those with others are required to be shown separately. There should be separately shown balances lying with bankers on current accounts, call accounts and deposit accounts. In respect of balances with other than Scheduled Banks, the balances lying with each such banker on different accounts and the maximum amount outstanding at any time during the year from each such banker should be disclosed. The nature of interest of a director, his relative, the managing agent, secretaries and treasurers or associate of managing agent or secretaries and treasurers in each of the bankers (other than Scheduled Banks) should be stated.

(B) LOANS AND ADVANCES:

(8) Advances and Loans to subsidiaries.

(9) Bills of Exchange.

(10) Advances recoverable in cash or in kind or for value to be received *e.g.*, Rates, Taxes, Insurance, etc.

(11) Balances on current account with Managing Agents or Secretaries and Treasurers.

(12) Balances with Customs, Port Trust etc. (where payable on demand).

The provisions in regard to diclosure of information in respect

of "sundry debtors" also apply to "loans and advances" and in addition note (i) requires diclosure of information as follows:—

(*a*) amounts due by the Managing Agents or Secretaries and Treasurers either severally or jointly with any other persons;

(*b*) amounts due from other companies under the same management with the names of the companies—vide Section 370 (IB); and

(*c*) the maximum amount due from every one of these *at any time* during the year.

X. MISCELLANEOUS EXPENDITURE.

The miscellaneous expenditure to the extent not written off or adjusted should be classified as follows:—

(1) Preliminary expenses.
(2) Expenses including commission or brokerage on underwriting or subscription of shares or debentures.
(3) Discount allowed on the issue of shares or debentures.
(4) Interest paid out of capital during construction (also stating the rate of interest).
(5) Development expenditure not adjusted.
(6) Other items (specifying nature).

Profit and Loss Account

Where interest is paid out of capital, Section 208 provides that the sums so paid by way of interest may be charged to capital as part of the cost of construction of the work or building or the provision of the plant. If the interest is capitalised in the manner aforesaid, it appears that it will not be required to be shown separately under item (4) above.

The debit balance of profit and loss account carried forward after deduction of the uncommitted reserves, if any, should be shown separately under the item "Profit and Loss Account."

(c) Requirements as to Profit and Loss Account

It is already observed that Section 211 requires that profit and loss account of a company should give a true and fair view of the profit or loss of the company for the financial year and should comply with the requirements of Part II of Schedule VI, so far as they are applicable thereto.

The said requirements do not apply to insurance or banking company or any company engaged in the generation or supply of electricity or to any other class of company for which a form of profit and loss account has been specified in or under the Act governing such class of company. The power of the Central Government to exempt any company from the above provisions has been already discussed.

The Act does not prescribe any form of profit and loss account but it merely gives the requirements in regard to the matters to be stated in the profit and loss account.

The requirements of the said Part II, apply in like manner to the income and expenditure account as they apply to a profit and loss account.

The general requirements in regard to the profit and loss account are as under:

1. The profit and loss account should be so made out as clearly to disclose the result of the working of the company during the period covered by the account.
2. It should disclose every material feature relating to the working results of the company's business.
3. It should also disclose clearly credits or receipts and debits or expenses in respect of non-recurring transactions or transactions of an exceptional nature.
4. It should set out the various items relating to the income and expenditure of the company arranged under the most convenient heads.
5. The comparative figures relating to the corresponding previous period, whether a year, half year or a quarter, should be given in the profit and loss account. The comparative figures should be regrouped wherever necessary and in that case a note should be placed at the foot of the profit and loss account to that effect.
6. It should disclose in particular the information required by clause 3 of Part II and it should contain or give by way of a note information required by clauses 4, 4A and 4B.

Under clause 3, profit and loss account should disclose, in particular the following information in respect of the period covered by the account:

I. *Turnover.*

The aggregate amount for which sales are effected by the company must be shown at the gross figure. The turnover may be shown after making adjustments in respect of return of goods, trade discounts and allowances etc.

The following amounts should not be deducted from sales but should be shown separately:

(*a*) Commission paid to sole selling agents within the meaning of Section 294 of the Act.

(*b*) Commission paid to other selling agents.

(*c*) Brokerage and discount on sales, other than the usual trade discount. The usual trade discount according to usual accounting practice should be deducted from the sales but the particulars of any *unusual* trade discount should be separately disclosed.

II. *Stocks, Purchases, etc.*

1. In the case of manufacturing concerns, the opening stock, purchases, closing stock and sales, if any, of raw materials should be separately stated. The usual practice is to show the opening stock plus purchase of raw materials, minus the closing stock so as to show the amount of raw materials consumed.

The opening stock and the closing stock of the goods produced should be separately shown.

2. In the case of trading concerns, the purchases, opening and closing stocks of goods should be separately shown.
3. In the case of concerns rendering or supplying services, the gross income derived from services rendered or supplied should be stated.
4. The concerns which fall under more than one of the above categories, are required to show the total amounts in respect of opening stocks, closing stocks, purchases, sales and gross income from services rendered.
5. In the case of concerns other than the above, the gross income derived under the different heads should be shown.

From the above requirements it will be noted that the component items of a trading account are required to be shown separately so as to clearly show how the gross profit is derived.

III. *Works in progress.*

In the case of all concerns having works in progress there should be shown:

1. The amounts for which such works have been completed at the commencement of the accounting period, and
2. The amounts for which such works have been completed at the end of the accounting period.

In the case of manufacturing concerns it is recommended that the opening and the closing stocks of semi-finished goods or the opening and the closing amount of works in progress, as the case may be, should be stated.

IV. *Provision for depreciation.*

The amount provided for depreciation, renewals or diminution in value or fixed assets should be separately stated. It is suggested that the particulars of any obsolescence loss written off should be separately given.

Where such provision is not made by means of a depreciation charge, the method adopted for making such provision and the amount should be stated.

In case no provision is made for depreciation, the fact that no provision has been made should be stated.

The quantum of arrears of depreciation computed in accordance with Section 205(2) of the Act should be disclosed by way of a note.

The provision for depreciation, in excess of the amount, which, in the opinion of the directors is reasonably necessary for the purpose, should be treated as a reserve and not as a provision. If there has been any change in the method of depreciation the effect of the change should be clearly stated by way of a note.

V. *Interest.*

The amount of interest on the company's debentures and loans for fixed periods should be separately stated.

There should be stated separately the amount of interest, if any, paid or payable to:

1. The managing director.
2. The managing agent.
3. The secretaries and treasurers, and

4. The manager.

VI. *Provision for taxation.*

The amount of charge for Indian income-tax and other Indian taxation on profits should be shown separately.

Where practicable, with Indian income-tax there should be also stated any taxation imposed elsewhere to the the extent of the relief, if any, from the Indian income-tax.

Where practicable, a distinction should be made between income-tax and other taxation. Different types of taxes should be shown separately

Any adjustment to the provision for taxation on determination of the actual liability should be adjusted through the profit and loss appropriation account and the difference, if material, should be clearly shown. This subject dealt with further in § 9 *infra.*

VII. *Reserves for repayment of share capital or loans.*

The amounts reserved for:

1. Repayment of share capital; and
2. Repayment of loans

are to be shown separately.

It is unusual for a company to make provision for repayment of share capital. However, in the case of redeemable preference shares it is possible that the terms of issue may require the company to reserve a part of the profit for ultimate redemption of such preference shares.

The reserve created for redemption of debentures should be separately shown.

VIII. *Reserves.*

The aggregate, if material, of any amounts set aside or proposed to be set aside to reserves must be separately shown. Such amounts should not include provisions made to meet any specific liability, contingency or commitment known to exist at the date as at which the balance sheet is made out. For this purpose the distinction between "provision" and "reserve" should be borne in mind.

The aggregate, if material, of any amounts withdrawn from such reserves also must be separately shown.

IX. *Provisions.*

The aggregate, if material, of the amounts set aside to make provision for specific liabilities, contingencies or commitments should be separately shown.

The aggregate, if material, of the amounts withdrawn from such provisions, as no longer required, should be separately stated.

Clause 5, Part II, Schedule VI, provides as under:—

> The Central Government may direct that a company shall not be obliged to show the amount set aside to provisions other than those relating to depreciation, renewal or diminution in value of assets, if the Central Government is satisfied that the information should not be disclosed in the public interest and would prejudice the company, but subject to the condition that in any heading stating an amount arrived at after taking into account the amount set aside as such, the provision shall be so framed or marked as to indicate that fact.

Where additions to or withdrawals from reserves and provisions have been made during the year and such transfers affect the profit and loss account, the amounts involved, if material, must be shown separately in that account or by way of a note. Where, however, the additions or withdrawals are capital transactions, *e.g.*, a transfer to capital reserve of a capital profit, such transactions should either appear on the face of the balance sheet or in a statement or report annexed thereto. The source from which the increase has been derived or the manner in which the decrease has been applied must be shown clearly.

The amount of provision, in excess of the amount which in the opinion of the directors is reasonably necessary for the purpose, should be treated as a reserve and not as a provision.

A proper distinction must be made between provisions and liabilities. Only the amount retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy should be termed as a provision. The expression "liability" includes all liabilities in respect of expenditure contracted for and all disputed or contingent liabilities.

X. *Other expenditure.*

The expenditure incurred on each of the following items should be shown separately:

1. Consumption of stores and spare parts. It is not necessary to disclose separately the opening stock, purchases and closing stock of stores and spare parts. It is suggested that where the sales of such items are material, such amounts should be separately disclosed.
2. Power and fuel.
3. Rent—including rent for factory, office, godowns etc.
4. Repairs to buildings.
5. Repairs to machinery.

Where repairs to buildings or machinery have been carried out departmentally, it is recommended that the expenditure under various heads such as salaries and wages, stores, etc., should be allocated to repairs account and the expenses so allocated should also be indicated by way of a note under their respective heads.

6. (*a*) Salaries, wages and bonus including gratuity, compensation etc.
   (*b*) Contribution to provident and other funds.
   (*c*) Workmen and staff welfare expenses to the extent not adjusted from any previous provision or reserve. If such expenditure is adjusted against any previous provision or reserve, such information should also be given in the balance sheet under the relevant provision or reserve account.
7. Insurance.
8. Rates and taxes, excluding taxes on income. This item will cover local taxes, property tax, water tax, vehicle tax, State sales-tax, Central sales-tax etc. It is suggested that the amount of sales-tax should be separately shown.
9. Miscellaneous expenses.

   It is recommended that where an item of expenditure is important, it should be separately stated.

XI. *Income from investments*

The amount of income from:

Trade investments and other investments should be separately shown.

Other income by way of interest must be separately stated, specifying the nature of the income.

If the gross income is stated in respect of the above items, the amount of income-tax deducted must be separately shown.

XII. *Profits or losses etc.*

1. The profits or losses on investments to the extent not adjusted from any previous provision or reserve should be shown separately. If the profits or losses on investments are adjusted against any previous provision or reserve such information should also be given in the balance sheet under the relevant provision or reserve account.
2. Profits or losses, if material in amount, in respect of transactions of a kind, not usually undertaken by the company or undertaken in circumstances of an exceptional or non-recurring nature should be shown separately.
3. Miscellaneous income.
   It is recommended that where the amount of miscellaneous income is material in amount the nature of the income should be stated.

XIII. *Subsidiary companies.*

The amount of dividend from subsidiary companies and provisions for losses of subsidiary companies, should be separately stated. Note (f) under the form of balance sheet requires that dividends declared by subsidiary companies after the date of the balance sheet should not be included unless they are in respect of period which closed on or before the date of the balance sheet.

XIV. *Dividends.*

The aggregate amount of dividends paid and proposed should be stated separately. It should also be stated whether such amounts are subject to deduction of income-tax or not.

XV. *Basis of accounting.*

The amount by which any items shown in the profit and loss account are affected by any change in the basis of accounting, if

material, should be disclosed. If there has been any change in the method of valuation of stock-in-trade or work-in-progress or in the basis of providing for depreciation or any change from the cash to the mercantile system of accounting, the effect should be clearly disclosed.

Clause 4, Part II, Schedule VI, requires that the profit and loss account should contain or give by way of a note detailed information in respect of payments provided or made during the financial year to:—

1. Directors.
2. Managing directors.
3. Managing agents.
4. Secretaries and treasurers, or
5. Manager.

The disclosure should be not only in respect of payments provided or made by the company but also by the *subsidiaries* of the company and *any other person.* Such information should be detailed as under:

1. Managerial remuneration under Section 198 of the Act paid or payable during the financial year to the directors (including managing directors), the managing agent, secretaries and treasurers or manager, if any.
2. Expenses reimbursed to the managing agent under Section 354.
3. Commission or other remuneration payable separately to a managing agent or his associate under Sections 356, 357 and 358.
4. Commission received or receivable under Section 359 of the Act by the managing agent or his associate as selling or buying agent of other concerns in respect of contracts entered into by such concerns with the company.
5. The money value of the contracts for the sale or purchase of goods and materials or supply of services, entered into by the company with the managing agent or his associate under Section 360 during the financial year.
6. Other allowances and commission including guarantee commission (details to be given).
7. Any other perquisites or benefits in cash or in kind (stating

approximate money value where practicable).

8. Pensions, etc:—
   (*a*) Pensions.
   (*b*) Gratuities.
   (*c*) Payments from provident funds, in excess of own subscriptions and interest thereon.
   (*d*) Compensation for loss of office.
   (*e*) Consideration in connection with retirement from office.

It should be noted that Section 221 casts a duty on the officer of the company and other persons to give particulars and information required to be given in the balance sheet or profit and loss account of a company. Such particulars and information should be furnished by them in as full a manner as possible whenever so required by the company's auditor.

Clause 4A requires that the profit and loss account should contain or give by way of a note a statement showing the computation of net profits in accordance with Section 349 of the Act together with relevant details of the calculation of the commissions payable by way of percentage of such profits to:

1. Directors.
2. Managing directors.
3. Managing agents.
4. Secretaries and treasurers, or
5. Manager.

Clause 4B requires that the profit and loss account should contain, or give by way of a note, detailed information in regard to amounts paid to the auditor, whether as fees, expenses, or otherwise for services rendered—

(*a*) as auditor; and
(*b*) in any other capacity.

Section 293A (2) requires that every company must disclose in its profit and loss account the amounts contributed to any political party or to any individual or body for any political purpose, during the financial year to which that account relates. Particulars of the total amounts contributed and the name of the party, individual or body to which or to whom such amount has been contributed must also be given. The company must also disclose the total amount contributed to National Defence Fund or other

approved funds for the purpose of National Defence, during the financial year to which the account relates.

§ 5. The Form of Final Accounts

Apart from the final accounts required for statutory purposes, the auditor is very often asked to prepare, in his capacity as accountant, the balance sheet and the profit and loss account of an undertaking. In doing this, he should bear in mind that these accounts should afford his client as much information as possible, and he must take into consideration the ability of his client to understand formal accounts.

For this reason it is sometimes advisable to prepare the profit and loss account in the form of a statement, rather than a ledger account.

The following is a condensed form of a profit and loss statement of this nature suitable for a sole trader:

	Rs.	Rs.
SALES *Less* RETURNS.		
Deduct—		
Cost of Manufacturing:		
Wages.		
Materials.		
General Manufacturing Expenses.		
GROSS PROFIT.		
OTHER INCOME.		
Deduct—		
Expenses (detailed)		
Deduct—		
Interest on Loans.		
Other fixed Charges.		
NET PROFIT FOR THE YEAR		
EXCEPTIONAL PROFITS.		
Deduct—		
Exceptional charges not applicable to the operations of the year.		
TOTAL PROFIT FOR YEAR		

In case of a company where the profit and loss account is prepared for other than statutory purposes, it is recommended that the profit and loss account should not be prepared in the conventional ledger account form but in the form of a financial statement as shown below so that it can be more intelligible to persons unversed in the science of accounting.

A typical published profit and loss account set out in this form is given below.

				Previous year
	Rs.	Rs.	Rs.	Rs.
TRADING PROFIT, after deducting all working costs and the items shown below		11,07,000	12,67,500	
DIRECTORS' REMUNERATION				
Fees Rs. 10,000				10,000
Emoluments 1,50,000				1,30,000
Pensions 10,000				5,000
		1,70,000		
DEPRECIATION	2,85,000			2,90,000
Debenture Interest	..			10,000
	Rs. 4,55,000			Rs. 4,45,000
DIVIDENDS AND INTEREST RECEIVABLE				
Trade Investments	64,500			70,000
Other Investments	2,32,000			2,00,000
		2,96,500	2,70,000	
		14,03,500	15,37,500	
EXCEPTIONAL PROFITS				
Profit on sale of raw materials no longer required.		80,000	..	
NET PROFIT for year before charging taxation thereon.	C/f.	14,83,500	15,37,500	

B/f.		14,83,500	15,37,500	
INDIAN TAXATION (estimated to be payable on the net profit shown above):				
Income Tax		8,80,000	9,50,000	
NET PROFIT FOR YEAR AFTER TAXATION		6,03,500	5,87,500	
APPROPRIATIONS				
General reserve	1,00,000			1,00,000
Debenture redemption	..			50,000
		1,00,000	1,50,000	
		5,03,500	4,37,500	
BALANCE BROUGHT FORWARD from previous year		2,12,400	1,04,900	
BALANCE AVAILABLE for distribution		7,15,900	5,42,400	
DIVIDENDS PAID AND PROPOSED on the company's ordinary shares: Interim dividend of 10%	1,10,000			
Proposed final dividend of 20%	2,20,000			
		3,30,000	3,30,000	
BALANCE CARRIED FORWARD		Rs. 3,85,900	2,12,400	

A balance sheet is a classified summary of the balances remaining in a set of books, after the profit and loss account has been prepared, and including the balance of that account. Except in the case of current assets whose market value at the relevant date is less than their cost, a balance sheet does not profess to disclose either the realisable or the "going concern" value of the assets. What it does show is the capital employed in the business and the various sources from which such capital is derived, and, under appropriate headings, the expenditure incurred in the acquisition of assets used in the business to the extent that it has not been used up or written off. In other words, a balance sheet is little more than a statement of unexpired or unexhausted expenditure. Although a balance sheet may afford useful information as to the nature of the security underlying the share capital, as to the adequacy or otherwise of the liquid resources, and as to the general financial stability of the concern, it gives no indication of its income earning capacity, which is the principal factor to be considered in estimating the proprietorship worth of a business.

Assets and liabilities should be properly grouped and arranged in logical order, and separate sub-headings and sub-totals should be shown of the various groups. All reserves and other balances representing undistributed profits should be aggregated with the issued share capital to show in one total the interest of the proprietors in the assets of the company. Where a balance sheet is prepared for other than statutory purposes, the modern practice is to present the same in the form of a statement which reveals to a layman more clearly the manner in which the company's capital has been invested. The following is an illustration of a balance sheet in this form.

FIXED ASSETS—	Rs.	Rs.
Land and Buildings at cost		30,00,000
Plant and Machinery at cost	20,00,000	
Less: Provision for depreciation to date	4,00,000	
		16,00,000
Goodwill, Patents, etc., at cost		
Less: Amounts written off		24,00,000
Total fixed Assets	C/f.	70,00,000

Deduct: B/f.			70,00,000
Debentures carrying a fixed charge on the Land and Buildings, plus accrued interest.			1,56,000
Fixed Assets, *less* specific charges			68,44,000
CURRENT ASSETS—			
Stock-in-Trade at cost		2,25,000	
Work-in-Progress at prime cost		1,09,000	
Sundry Debtors		1,81,000	
Bills Receivable		29,000	
Cash at Bank and in hand		65,000	
		6,09,000	
Deduct: Current Liabilities—			
Sundry Creditors	89,000		
Taxation	1,25,000		
		2,14,000	
Working Capital			3,95,000
Excess of assets over liabilities and specific provisions			72,39,000
Deduct:			
Debentures secured by a floating charge on the assets of the company			2,00,000
		Rs.	70,39,000
Representing:			
Capital and Reserves:			
Authorised and Issued Share Capital:			
3,00,000 5% Preference Shares of Rs. 10/- each			30,00,000
2,00,000 Ordinary Shares of Rs. 10/- each			20,00,000
			50,00,000

Revenue Reserves:		
General Reserve	15,00,000	
Profit and Loss Account	3,89,000	
		18,89,000
		68,89,000
Amount set aside for future taxation		1,50,000
	Rs.	70,39,000

§ 6. Holding and Subsidiary Companies

(A) DEFINITIONS

Section 4, Companies Act, 1956, defines "holding company" and "subsidiary". Section 4(1) provides that a company, subject to the provisions of sub-section (3), shall be deemed to be a subsidiary of another if, but only if,—

(*a*) that other controls or by virtue of Section 4(2) is deemed to control the composition of its Board of directors; or

(*b*) that other—

(*i*) where the first-mentioned company is an existing company in respect of which the holders of preferenc shares issued before the commencement of this Act have the same voting rights in all respects as the holders of equity shares, exercises or controls more than half of the total voting power of such company;

(*ii*) where the first-mentioned company is any other company, holds more than half in nominal value of its equity share capital; or

(*c*) the first-mentioned company is a subsidiary of any company which is that other's subsidiary.

Section 4(3) provides as under:

In determining whether one company is a subsidiary of another—

(*a*) any shares held or power exercisable by that other company in a fiduciary capacity shall be treated as not held or exercisable by it;

(*b*) subject to the provisions of clauses (*c*) and (*d*), any shares held or power exercisable—

(*i*) by any person as a nominee for that other company (except where that other is concerned only in a fiduciary capacity J); or

(*ii*) by, or by a nominee for, a subsidiary of that other company, not being a subsidiary which is concerned only in a fiduciary capacity;

shall be treated as held or exercisable by that other company;

(*c*) any shares held or power exercisable by any person by virtue of the provisions of any debentures of the first-mentioned company or of a trust deed for securing any issue of such debentures shall be disregarded;

(*d*) any shares held or power exercisable by, or by a nominee for, that other or its subsidiary [not being held or exercisable as mentioned in clause (*c*)] shall be treated as not held or exercisable by that other, if the ordinary business of that other or its subsidiary, as the case may be, includes the lending of money and the shares are held or the power is exercisable as aforesaid by way of security only for the purposes of a transaction entered into in the ordinary course of that business.

Sub-sctions (6) and (7) make provisions in respect of a body corporate which is incorporated in a country outside India.

(B) REQUIREMENTS AS TO BALANCE SHEET, ETC.

Under Part I, Schedule VI, the Balance Sheet of a holding company, should separately disclose:

1. Secured loans and advances from subsidiaries;
2. Unsecured loans and advances from subsidiaries;
3. Current liabilities due to subsidiaries;
4. Investments in shares, debentures or bonds of subsidiary companies;
5. Advances and loans to subsidiaries.

In case of a subsidiary company, the number of shares held by the holding company as well as by the ultimate holding company and its subsidiaries must be separately stated under the head "Share Capital".

Section 212 provides that there should be attached to the Balance Sheet of a holding company having a subsidiary or subsidiaries at the date of its Balance Sheet, the following documents in respect of each such subsidiary:—

(*a*) a copy of the balance sheet of the subsidiary;
(*b*) a copy of its profit and loss account;
(*c*) a copy of the report of its Board of directors;
(*d*) a copy of the report of its auditors;
(*e*) a statement of the holding company's interest in the subsi-

sidiary as specified in sub-section (3) which reads as under:

The statement referred to in clause (*e*) of sub-section (1) shall specify—

(*a*) the extent of the holding company's interest in the subsidiary at the end of the financial year or of the last of the financial years of the subsidiary referred to in sub-section (2);

(*b*) the net aggregate amount, so far as it concerns members of the holding company and is not dealt with in the company's accounts, of the subsidiary's profits after deducting its losses or *vice versa*—

(*i*) for the financial year or years of the subsidiary aforesaid; and

(*ii*) for previous financial years of the subsidiary since it became the holding company's subsidiary;

(*c*) the net aggregate amount of the profits of the subsidiary after deducting its losses or *vice versa*—

(*i*) for the financial year or years of the subsidiary aforesaid; and

(*ii*) for the previous financial years of the subsidiary since it became the holding company's subsidiary;

so far as those profits are dealt with, or provision is made for those losses, in the company's accounts.

Clauses (*b*) and (*c*) of sub-section (3) shall apply only to profits and losses of the subsidiary which may properly be treated in the holding company's accounts as revenue profits or losses, and the profits or losses attributable to any shares in a subsidiary for the time being held by the holding company or any other of its subsidiaries shall not (for that or any other purpose) be treated as aforesaid so far as they are profits or losses for the period before the date on or as from which the shares were acquired by the company or any of its subsidiaries, except that they may in a proper case be so treated where—

(*a*) the company is itself the subsidiary of another body corporate; and

(*b*) the shares were acquired from that body corporate or a subsidiary of it;

and for the purpose of determining whether any profits or losses are to be treated as profits or losses for the said period, the profit or loss for any financial year of the subsidiary may, if it is not practicable to apportion it with reasonable accuracy by reference to the facts, be treated as accruing from day to day during that year and be apportioned accordingly.

(*f*) the statement referred to in sub-section (5)—which provides as under:

Where the financial year or years of a subsidiary referred to in sub-section (2) do not coincide with the financial year of the holding company, a statement containing information on the following matters shall

also be attached to the balance sheet of the holding company:—

(*a*) whether there has been any, and, if so, what change in the holding company's interest in the subsidiary between the end of the financial year or of the last of the financial years of the subsidiary and the end of the holding company's financial year;

(*b*) details of any material changes which have occurred between the end of the financial year or of the last of the financial years of the subsidiary and the end of the holding company's financial year in respect of—

(*i*) the subsidiary's fixed assets;

(*ii*) its investments;

(*iii*) the moneys lent by it;

(*iv*) the moneys borrowed by it for any purpose other than that of meeting current liabilities.

(*g*) the report referred to in sub-section (6) which provides that—

If, for any reason, the Board of directors of the holding company is unable to obtain information on any of the matters required to be specified by sub-section (4), a report in writing to that effect shall be attached to the balance sheet of the holding company.

The Central Government may, on the application or with the consent of the Board of directors of the company, direct that the provisions of Section 212 shall not apply in relation to any subsidiary or shall apply only to such extent as may be specified in the direction.

The balance sheet referred to in clause (*a*) above should be made out in accordance with the following requirements:—

(1) Where the financial year of the subsidiary does not coincide with that of the holding company, the balance sheet of the subsidiary should be prepared as at the end of the last financial year of the subsidiary ending before that of the holding company.

(2) Where the financial year of the holding company coincides with that of the subsidiary, the balance sheet should be prepared as at the end of the financial year of the subsidiary.

The profit and loss account, the report of the Board of directors and the report of the auditors referred to above should be made out for the financial year of the subsidiary company as aforesaid.

Where the financial years of the subsidiary and the holding company do not coincide, the financial year of the subsidiary should not end on a day which precedes the end of the holding company's financial year by more than six months.

In case, the financial year of a subsidiary is shorter than that of a holding company, the financial year of the subsidiary for the purposes of clauses (a), (b) and (c) mentioned above would mean two or more financial years of the subsidiary the duration of which, in the aggregate, does not exceed that of the holding company's financial year.

The persons referred to in Section 209 (6) or persons charged with the duty of seeing that the provisions of Section 212 are complied with, are liable to imprisonment upto six months or a fine upto rupees one thousand or both for default in compliance with the provisions of Section 212.

Section 213 gives power to the Central Government to issue necessary directions to enable the holding company or a subsidiary to extend the financial year so that the financial years of both of them may coincide.

(c) Rights in Respect of Books of Subsidiaries

Under Section 214, a holding company may, by resolution, authorise representatives named in the resolution to inspect the books of account kept by any of its subsidiaries. Such books of account shall be open to inspection by those representatives at any time during business hours.

The right conferred by Section 235, to apply to the Central Government for investigation of the affairs of a company may be exercised, in respect of any subsidiary, by members of the holding company as if they alone were members of the subsidiary.

(d) Audit of Holding Company

In the accounts of the holding company the shares held in and indebtedness to and by subsidiaries must be shown separately, and in order that he may report that the Balance Sheet shows a true and fair view of the affairs of the company, the auditor must take whatever steps may be necessary to satisfy himself as to the values placed upon these items. In this respect his duty differs in no way from that in relation to other assets and liabilities of the

holding company.

For the purpose of such verification the auditor should examine the last Balance Sheets and accounts of the subsidiary companies in order to form an opinion whether or not the shares held therein are worth the values placed upon them in the holding company's Balance Sheet. If it is found that any of the subsidiary companies have suffered losses, this might have the effect of reducing the value of the shares below their book value, and if such diminution in value has not been provided for in the accounts of the holding company, the auditor should refer to this fact in his report.

The Balance Sheets and Profit and Loss Accounts of the subsidiaries should also be consulted by the auditor of the holding company, to enable him to verify to what extent the profits or losses of the subsidiary companies have been incorporated in the holding company's accounts. Furthermore, where a subsidiary company is indebted to its holding company, an examination of the Balance Sheet and accounts of that subsidiary by the auditor of the holding company is necessary to ascertain whether that subsidiary is apparently solvent, and whether or not some provision for possible loss in connection with the indebtedness of the subsidiary should be made by the holding company.

(E) The Consolidation of Accounts

Even though there is no statutory requirement for consolidation of accounts of holding and subsidiary companies the auditor is very often asked to prepare, in his capacity as accountant, the group accounts.

In the large majority of cases the group accounts take the form of consolidated accounts, in which the whole group is regarded as one undertaking, and the whole of the assets and liabilities of all the companies in the group are incorporated in one Balance Sheet. Similarly, the income and expenditure of all the companies are combined in one Profit and Loss Account. The members are thus able to form some opinion as to the security underlying their shares. It also makes it possible for them to see what surplus is available for dividend purposes, and how much of the capital of the holding company is represented by payments for goodwill, or the cost of acquiring control of the subsidiaries.

On the other hand, consolidated accounts may be objected to

on the ground that they do not show which of the constituent companies are earning profits, and which are making losses. This may be important where the bulk of the profits are earned by a company which has small capital commitments, whereas other companies which have heavy liabilities in the form of debentures, etc., are making losses.

For the purpose of preparing consolidated accounts, regard must be had *inter alia* for the following:

(*i*) The Balance Sheets of all the companies must be made up to the same date, or proper adjustments made to enable the exact position at the date of consolidation to be ascertained.

(*ii*) All assets and liabilities must be classified and valued on similar bases, or proper adjustments made to bring them on to similar bases.

(*iii*) A consolidated Balance Sheet is merely the Balance Sheet of the holding company, in which, however, the item "Shares in Subsidiary Companies" is replaced by the actual assets and liabilities of the subsidiary companies, which represent such shares. Where, therefore, the price paid for the shares exceeds the book value of the actual net assets of the subsidiary as at the date of acquisition, such excess represents the price paid for goodwill, and must be shown as such in the consolidated Balance Sheet, the other assets and liabilities being shown under their respective headings.

(*iv*) If the holding company does not own the whole of the capital of the subsidiaries, the consolidated Balance Sheet must show as a liability the total interests of all outside shareholders in the subsidiaries.

Alternatively, only the proportion of each separate asset and liability which is attributable to the capital in the subsidiary company held by the holding company may be included in the consolidated Balance Sheet, the interest of the outside shareholders being entirely eliminated. This latter method, however, may lead to complications, and is not to be recommended.

(*v*) In the consolidated Balance Sheet it is usual to credit

all reserves and profits of the subsidiary existing at the time of the acquisition of the controlling interest to a capital reserve, and then to transfer therefrom to the liability to outside shareholders the proportion attributable to their holding, carrying the balance to *contra* to be deducted from the excess of the cost of the shares over their nominal value in order to compute goodwill.

(*vi*) If the shares in the subsidiary were purchased at a discount (*i.e.*, the price paid for the shares was less than the net book value of the assets represented thereby) the discount must be deducted from goodwill. (If this results in a credit balance, then, following general accounting principles, there will be a capital reserve). If there was a deficiency of assets in the subsidiary (*e.g.*, a Profit and Loss Account debit balance) this must be added to the cost of goodwill, as the tangible assets are reduced by such deficiency.

(*vii*) Where the shares in the subsidiary were acquired some time prior to the date of the consolidated Balance Sheet, the reserves and Profit and Loss Account balances of the subsidiary will probably include profits earned *since* the acquisition of the shares. Such profits are divisible between the holding company and the outside shareholders—the holding company's proportion being transferred to the consolidated Profit and Loss Account, and the outside shareholders' proportion to the liability to outside shareholders. Only the reserves and profits in existence at the date of the acquisition are taken to capital reserve, all subsequent profits being properly taken to revenue.

(*viii*) If all or any of the preference shares in subsidiary companies are not held by the holding company the nominal value of the preference shares not so held should be shown as a liability.

(*ix*) Inter-company indebtedness must be set off, and not included either as an asset or as a liability in the consolidated Balance Sheet.

(*x*) Inter-company profits included in stocks or other assets, should be deducted from Profit and Loss Account, and

from the appropriate assets, so as to reduce these items to their cost to the combine. If, however, there are outside shareholders, only the holding company's proportion of such profit need be eliminated, since from the point of view of the outside shareholders, the profit *has* been realised, and to the extent that the profit is attributable to the shares held by outside shareholders it increases the cost of the goods to the combine.

(*xi*) In the consolidated Profits and Loss Account the proportion of the profit or loss attributable to outside shareholders must be deducted and included in the liability to outside shareholders in the consolidated Balance Sheet. Any inter-company dividends, purchases, sales, and expenses shown in the respective Profit and Loss Accounts will form *contra* items in the consolidated Profit and Loss Account, and will be eliminated therefrom.

If the auditor is required to report on consolidated accounts he should pay particular attention to the following matters:

(1) The computation of the amount shown under the heading of goodwill. This will consist of the amounts appearing as goodwill in the respective Balance Sheets plus the excess of the cost of the parent company's holdings in the subsidiary companies over the net assets represented by such holdings at the date of acquisition of the control, or less the excess of the net assets over the cost of the holdings at the same date.

(2) The liability to minority interests in the subsidiary companies. This will be represented by the nominal amount of the shares held by outside shareholders of the subsidiary companies, plus or minus the proportion of the reserves and Profit and Loss Account balances of the subsidiaries as at the date on which the consolidated Balance Sheet is drawn up.

(3) The adjustment of any inter-company liabilities.

(4) The elimination of unrealised inter-company profits.

(5) If any of the assets of the subsidiary companies have been

revalued for the purpose of the consolidated Balance Sheet, it should be seen that proper effect has been given to such revaluation in arriving at the amount of the goodwill and the liability to minority interests. It should also be ascertained that the charge to the consolidated Profit and Loss Account for depreciation, by reference to such revaluation, has been adjusted.

(6) In the consolidated Profit and Loss Account it should be seen that proper adjustment has been made for dividends paid by the subsidiary company to the parent company. If any dividend has been paid out of profits existing at the date on which the parent company acquired its holding in a subsidiary, such dividend should be deducted from the purchase price of the shares in arriving at the value of goodwill, and should not appear in the consolidated Profit and Loss Account. A holding company should not distribute as dividend any dividends received by it from subsidiaries which have been paid out of pre-acquisition profits. If the holding company has paid dividends out of the pre-acquisition profits of subsidiaries this fact must be made clear to the shareholders.

(7) The auditor must check, by reference to the accounts of the subsidiaries, the amount deducted in the consolidated Profit and Loss Account from the group profit for the year as representing the amount retained by the subsidiaries, in-so-far as it concerns the holding company.

(8) Where the accounts which have been consolidated are made up to different dates, the adjustments (if any) which have been made, in order to ensure that the financial position and the profit or loss of the group, as shown by the consolidated accounts, are not distorted or misrepresented.

Adjustments may be necessary in the following circumstances:

(*a*) Where a substantial trading loss is known to have been sustained by a subsidiary between the end of its financial year and the date of the consolidated accounts.

(*b*) Where the liquidity of the group has been materially changed by the transfer of cash or other assets from one member of the group to another, or where substantial

capital expenditure has been incurred, in the interval between the Balance Sheet dates

(c) For the purpose of reconciling the balances on inter-company accounts in respect of cash and other assets in transit.

(9) The conversion into rupees, for the purpose of the consolidated accounts, of the figures relating to foreign subsidiaries.

§ 7. Reserve Funds

The nature of reserves and the distinction between reserves and provisions have been discussed in Chapter IV, § 8, where the question as to whether a general reserve should be retained in the business or invested specifically outside the business is considered; and it is there pointed out that the term "reserve fund", cannot be employed where the reserve is not represented by specific investments outside the business. Part I of Schedule VI requires that the word "Fund" in relation to any "Reserve" should be used only where such reserve is specifically represented by earmarked investments.

Most companies have power to put profits to reserve before payment of any dividend, and clause 87 of Table A provides that the Board may, before recommending any dividend, set aside out of the profits of the company such sums as they think proper as reserve or reserves, which shall, at the discretion of the directors, be applicable for any purpose to which the profits of the company may be properly applied, and pending such application, may be employed in the business of the company, or invested in such investments as the directors may think fit.

If the Articles provide that a fixed percentage of the profits must be retained each year and placed to reserve until a certain sum has been accumulated the auditor should see that the provision is duly carried out. Such compulsory provision, however, is unusual, and normally the Articles leave the matter to the discretion of the directors. Where such discretion is given, it is a matter for the directors to determine how much of the profits of any one year they shall put to reserve before recommending the payment of a dividend, even though the result of their action may be to prevent payment of any dividend on founders' shares (*Fisher* v. *Black and White Publishing Co.*, 1901 1 Ch. 174), or

preference shares (*Bond* v. *Barrow Hæmatite Steel Co.*, 1902 1 Ch. 358).

In addition to appropriations of profits, exceptional profits may be placed direct to reserve. Where a sinking fund has been provided for the redemption of debentures, the amount standing to the credit of this account, when the redemption of the debentures has been accomplished, should be transferred to the credit of reserve and will be represented by the assets formerly subject to the charge contained in the debentures.

A reserve accumulated out of profits may be utilised in any manner in which the profits of the company may be applied and can be drawn upon for payment of dividends or to meet exceptional losses. Where a loss has been incurred on revenue account, such loss can be made good by a transfer from the reserve so long as the transfer is disclosed in the Profit and Loss Account. Any loss arising from diminution in value of the fixed or capital assets of the company may be written off against the Reserve Account.

Where the book value of the fixed assets is less than their real value and it is desired to write up the value of such assets in the Balance Sheet, the increase should be placed to the credit of a Capital Reserve Account, since it will not be available for revenue purposes, but any subsequent loss in connection with these assets may be charged against such reserve. Before passing any entries recording the appreciation of assets in this manner the auditor should ascertain by whom the revaluation has been made, and satisfy himself that it is *bona fide*.

Under no circumstances should such an appreciation be taken to the credit of revenue, unless it can be shown to have arisen by reason of excessive provisions for depreciation in the past; even then it would be more desirable to transfer the amount to the credit of reserve after adequate disclosure in the profit and loss account. It would appear, however, that a *bona fide* increase in the value of fixed assets can be utilised to extinguish the debit balance on Profit and Loss Account, thus leaving current profits available for the payment of dividend (*Ammonia Soda Company* v. *Chamberlain*, 1918 1 Ch. 266). This decision is more fully referred to in Chapter XI.

Many prosperous companies have accumulated large reserves,

which are used permanently in the business, and thus form part of the real capital employed. The rate of dividend paid on the issued share capital, however, does not represent the rate actually earned on the capital employed, and in many cases it has been thought desirable to bring the issued capital more into line with the capital employed, by capitalising a portion of the reserves by the issue of bonus shares to shareholders *pro rata* to their existing holdings.

In the majority of cases bonus shares are allotted by means of *renounceable allotment letters* thus enabling shareholders, within a specific time, to sell their new shares, if they so desire, by renunciation in favour of the buyers, free of stamp duty.

Where a bonus issue is contemplated, it should be seen that the Articles of the company permit such a capitalisation of profits and, if not, they should be altered by special resolution. The company must have sufficient unissued shares to enable the operation to be performed, otherwise it will be necessary to increase its capital.

It should be seen that the consent of the Controller of Capital Issue is obtained for the issue of bonus shares.

If the members do not have an unconditional right to take their dividends or bonuses in cash, should they wish to do so, the bonus issue will require a contract to be filed with the Registrar of Companies, constituting the title of the allottees to the shares, under Section 75, Companies Act, 1956.

A resolution having been passed by the company authorising the capitalisation of reserves, the directors should pass a resolution appropriating the amount agreed to the shareholders in proportion to their shareholdings to be applied on their behalf in paying up in full the new shares to be allotted to them. Arrangements are usually made for the sale of fractions of shares arising from the *pro rata* allotment and for the distribution of the proceeds amongst the shareholders entitled thereto.

Sometimes a bonus is satisfied by applying the amount thereof to discharging wholly or partly the uncalled liability on shares already issued. In this case the procedure is to declare the bonus out of reserve, and at the same time to make a call on the shares to a corresponding amount.

A reserve accumulated out of profits retains its revenue nature in the event of liquidation, and is divisible amongst the members in the proportion in which they are entitled to share the profits. If the Articles provide that the preference shareholders are entitled to profits in certain proportions and there are any arrears of preference dividend, preference shareholders will be entitled to such arrears out of the reserve (*Bishop* v. *Smyrna & Cassaba Railway*, 1895 2 Ch. 596); but where the right of such preference shareholders to dividends only accrues after a resolution to pay such dividend has been passed by the directors, and the company goes into liquidation before any such resolution is passed, the preference shareholders will have no claim against the reserve in respect of arrears of dividend (*Crichton's Oil Co.*, 1901 2 Ch. 184; 1902 2 Ch. 86).

The ultimate distribution of surplus assets after repaying to members the nominal amount of their capital, whether such surplus is represented by a reserve or not, must depend upon the rights of the respective classes of members as defined in the Articles.

§ 8. Secret or Internal Reserves

Prior to the coming into operation of the Companies Act, 1956, many companies created secret or inernal reserves, and in some cases the practice was abused by the directors, with the result that shareholders were presented with most misleading financial statements.

A secret reserve may be defined as a reserve, the existence and/or amount of which is not disclosed on the face of the Balance Sheet.

By virtue of the provisions of the Companies Act, 1956, however, the subject of secret reserves is now largely one of academic interest. If there has been an appreciation in the value of fixed assets which is unrecorded, or goodwill has been written down below its true value, the company has to this extent a secret reserve, but with such exceptions, for all practical purposes, secret reserves can no longer legally be created. The methods formerly adopted for the creation of secret reserves are no longer possible for the following reasons:

(*a*) The aggregate, if material, of any amounts set aside or proposed to be set aside to reserves or any amounts withdrawn from such reserves must be shown in the profit and loss account. [Schedule VI Part II Clause 3 para (viii)].

(*b*) The aggregate, if material, of the amounts set aside to provisions made for meeting specific liabilities, contingencies or commitments or the amount, if material, withdrawn from such provisions, as no longer required must be shown in the profit and loss account [Schedule VI Part II, Para 3 clause (ix)].

(*c*) The aggregate amount provided or written off since the date of acquisition or valuation of fixed assets must be shown separately on the Balance Sheet [Schedule VI Part I].

(*d*) The aggregate amounts of capital reserves, revenue reserves and provisions respectively must be shown separately on the Balance Sheet [Schedule VI Part I].

(*e*) Where any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, not being an amount written off in relation to fixed assets before the commencement of this Act; or any amount retained by way of providing for any known liability; is in excess of the amount which in the opinion of the directors is reasonably necessary for the purpose, the excess shall be treated for the purposes of the Schedule as a reserve and not as a provision, and the amount of such excess should be disclosed. [Schedule VI Part III para 7 (2)].

The fact that secret reserves are essential in the case of certain types of companies is however, recognised by the Act, which provides under Section 211 that the requirements of Schedule VI shall not apply to banking or insurance companies. The Central Government also have power, on the application or with the consent of a company's directors, to modify in relation to the company any of the above requirements, and in particular the Central Government may by notification exempt any class of companies from compliance with any of the requirements in Schedule VI if,

in its opinion, it is necessary to grant the exemption in the public interest.

§ 9. Taxation

It is not within the province of this work to consider in detail the question of taxation, either from a legal point of view, or from the practical aspect as affecting accounts.

It is not the duty of the auditor to prepare computations for taxation purposes and to submit them to the Income Tax authorities, although he frequently is called upon to do so in practice. The preparation of such computations should be undertaken by competent officials of the company, but where the auditor is asked to do such work, it will be performed by him as an accountant and not as auditor.

The auditor must, however, check the taxation computations in order to satisfy himself that the provision for taxation shown in the Profit and Loss Account is correct. It will be readily appreciated what a misleading impression could be created by a Balance Sheet in which there was an inadequate or grossly excessive provision for taxation, and as the auditor is required to report that the Balance Sheet shows a true and fair view of the state of the company's affairs, this duty cannot be discharged without proper consideration being given to the taxation liabilities included therein. The provision should be made for the *whole* of the tax for the current fiscal year, and *also* for the estimated tax on the current accounting year's profits, which will be assessed in the following fiscal year.

The amount set aside as provision for taxation must be shown in the Balance Sheet under the head "Provisions." The amount of provision in excess of the amount which in the opinion of the directors is reasonably necessary for the purpose, should be treated as a reserve and not as a provision.

In the Profit and Loss Account, the amount of charge for Indian income tax and other Indian taxation on profits, including, where practicable, with Indian income tax any taxation imposed elsewhere to the extent of the relief, if any, from Indian income tax must be shown. Where practicable, distinction should be made between income tax and other taxation. (Part II, Schedule VI).

The auditor must see that provision for taxation is made in respect of the different types of taxes, on income or otherwise, to which a company is subject, *e.g.*, (i) Income Tax and Super Tax (ii) Penal Tax under Section 104 (iii) Capital Gains Tax (iv) Bonus Tax (v) Additional Super Tax on excess dividends (vi) Tax payable in a foreign country (vii) Estate Duty as a controlled company (viii) Gift Tax.

The tax liability on income should be computed after having due regard to:

(i) Basis of accounting adopted for taxation purposes.
(ii) Claim for depreciation including extra shift allowance.
(iii) Claim for development rebate and provisions as to creation and maintenance of Development Rebate Reserve Account.
(iv) Compliance with Section 104, if applicable.
(v) Relief under Sections 84, 85 and 101 in respect of the profits of newly established industrial undertakings and dividends therefrom.
(vi) Exemption of Inter-company dividends under Section 99, from super tax.
(vii) Carry forward of past losses and arrears of depreciation allowances.
(viii) Expenses not deductible.

In arriving at the net tax liability of the company, the tax deducted at source and tax recouped from dividends should be taken into account.

The auditor must see that proper adjustments to Provision for taxation account have been made upon completion of assessments and determination of actual liability. It is suggested that excess provision for tax in respect of a particular year should be credited to the Profit and Loss Appropriation Account and the short provision for tax should be disclosed separately in the Profit and Loss Appropriation Account.

A company under the Income Tax law would meet its tax liability:

(i) by advance payment of tax;

(ii) by payment of tax on provisional assessment under Section 141;
(iii) by deduction of tax at source; and
(iv) on the completion of the regular assessments.

Until the assessment is completed the tax paid by the company, except on regular assessment, will stand debited to the respective accounts, as the case may be, and the said accounts should appear in the Balance Sheet on the assets side. On the completion of the assessment, the amount already paid by the company will be set off against provision for tax. If, on final assessment, the company is entitled to a refund, the amount of refund will be shown on the assets side of the Balance Sheet.

The auditor must see that proper provision is made in respect of any penalty payable by the company under any of the taxation laws. It should be seen that any interest on advance payment of tax is properly brought into account.

Where it appears that the company is entitled to make a claim or claims for the recovery of tax, the auditor should satisfy himself that these have been or will be made, and vouch the receipt of the refund in due course.

With regards dividends payable by a company, the balance of the Profit and Loss Account, after debiting the full income tax liability, represents the fund available for payment of dividends and hence the modern practice is to debit the provision for taxation to Profit and Loss Account and not to the Profit and Loss Appropriation Account. However, it is suggested that any adjustment to "provision for taxation" on completion of the assessments should be made through the Profit and Loss Appropriation Account, as such adjustments relate to the tax liability of the previous years.

§ 10. Filing of Annual Return and Balance Sheet

Under Section 159, every company, having a share capital, is required to prepare and file with the Registrar, within forty-two days from the day on which the annual general meeting is held under Section 166, a return containing the particulars specified in Part I of Schedule V of the Act as they stood on that day, regarding—

(*a*) its registered office,
(*b*) the register of its members,
(*c*) the register of its debenture holders,
(*d*) its shares and debentures,
(*e*) its indebtedness,
(*f*) its members and debenture holders, past and present, and
(*g*) its directors, managing directors, managing agents, secretaries and treasurers, managers and secretaries, past and present.

Where the annual general meeting for any year has not been held, the aforesaid requirements should be complied with, with reference to the latest day on or before which that meeting should have been held in accordance with the provisions of the Act. Sections 160, 161 and 162 contain further provisions in regard to the annual return.

Section 220 provides that, after the Balance Sheet and the Profit and Loss Account have been laid before a company at an annual general meeting, there should be filed with the Registrar at the same time as the copy of the annual return referred to in Section 161—

three copies of the Balance Sheet and the Profit and Loss Account together with three copies of all documents which are required by the Act to be annexed or attached to such Balance Sheet or Profit and Loss Account.

Provided that in the case of a private company, copies of the Balance Sheet and copies of the Profit and Loss Account should be filed with the Registrar separately.

These documents should be signed by the managing director, managing agent, secretaries and treasurers, manager or secretary of the company, or if there be none of these, by a director of the company.

If the Central Government directs that it is not in the public interest that any person other than a member of the company concerned shall be entitled to inspect or obtain copies of the Profit and Loss Account of the company, no person other than a member of the company concerned shall be entitled to inspect or obtain copies of the Profit and Loss Account of:

(*i*) a private company which is not a subsidiary of a public company; or

(*ii*) a private company of which the entire paid up share capital is held by one or more bodies corporate incorporated outside India; or

(*iii*) a company which becomes a public company by virtue of Section 43A.

If the annual general meeting of a company before which a Balance Sheet is laid, does not adopt the Balance Sheet, a statement of that fact and of the reasons therefor must be annexed to the Balance Sheet and to the copies thereof required to be filed with the Registrar.

CHAPTER XI

DIVISIBLE PROFITS AND DIVIDENDS

§ 1. The Ascertainment of Profits

The proper ascertainment of profits in the case of a company is a matter of very great importance, affecting the rights and interests of various parties in different ways. If the profits shown in the accounts have been arrived at incorrectly, and are in excess of the actual profits, and further, if they have been distributed in dividend, the effect may be that the dividend will have been paid out of capital in whole or in part, and that the capital fund contributed by the members will not remain intact.

Similarly, such a proceeding might affect the rights of debenture holders, since the dividend so paid away would have the result of depleting the assets which form their security.

If the improper distribution of dividends has so depleted the funds of the company that the remaining assets are insufficient to provide for the payment of ordinary creditors, the interests of the latter are obviously affected; while the directors of the company may make themselves personally liable to account for any dividends paid out of capital.

Further, there may be third parties enitled to a share of the profits, such as directors, managers, or others, who receive a percentage thereof.

If the total assets of a business are valued at the commencement of the year, the difference between this sum and the total of liabilities and capital at that date represents a surplus or deficiency, as the case may be. If a similar valuation is made at the end of the year and the surplus is found to have increased, or the deficiency decreased, such difference, subject to any appropriations of profit or adjustments of capital, is the profit for the period, while if the surplus has decreased, or the deficiency increased, such difference is the loss for the period.

It is clear that the amount of profits so arrived at is dependent upon the method employed in determining the value of the assets.

If all the assets were valued at the amounts they are expected to realise if the business were closed down, a loss would probably be shown and this method is not therefore adopted, the valuation being made on the basis of a going concern. It is necessary, however, to distinguish between the various classes of assets, since if fixed assets representing capital expenditure, such as freehold land, rise in value, and this increase is taken into account, it represents an unrealised increment which may never materialise into a tangible profit.

Fixed assets, therefore, are generally valued at their cost price, less a proper allowance for any depreciation which has arisen as a result of their being utilised in carrying on the business.

Similarly, current assets should not be valued above cost, as this would involve taking profit before it is realised, the proper basis of valuation being cost or realisable value, whichever is the lower.

In effect, therefore, the profits for a given period may be said to be the excess of current income over current expenditure, after making good any loss sustained by fixed or current assets during that period in the process of earning such income.

It does not follow, however, in the case of a company, that profits so arrived at are necessarily divisible profits. The divisible profits should be ascertained having regard to the provisions of Section 205 of the Companies Act, 1956 and in each case the provisions of the Memorandum and Articles of Association and their validity must be considered. It will be necessary to make various appropriations from the profits before any balance is available for distribution.

Before proceeding, however, to a detailed consideration of the provisions of the Companies Act, 1956 and the relevant case law on divisible profits, it is important to note the following decisions dealing with the ascertainment of profits.

(A) LEGAL DECISIONS

(1) *The Spanish Prospecting Co., Ltd.,* (1911 1 Ch. 92).

In this case the company had entered into an agreement with two men, A and B, who were to receive a salary at the rate of £41-13s-4d. per month each, subject to the proviso that they should not be entitled to draw their salary "except only out of

profits," if any, arising from the business of the company, which might from time to time be available for such purpose. Any such salary was to be cumulative, and any arrears thereof payable out of succeeding profits.

The business of the company included the purchase and sale of shares; and certain debentures which had been acquired stood in the books at no value.

The company went into liquidation while the debentures were still unsold, but they were subsequently realised by the liquidator and it was claimed that the proceeds should be credited to the Profit and Loss Account, in order to enable A and B to receive their salaries out of the profits arising therefrom. Swinfen Eady, J., decided that a surplus on realised assets in winding-up, over and above the subscribed capital, was not a profit arising out of the business of the company; but the Court of Appeal reversed the decision, and indicated that the proceeds could be properly credited to Profit and Loss Account.

Fletcher Moulton, L.J., said:

"... We start therefore with this fundamental definition of "profits," viz., if the total assets of the business at the two dates be compared, the increase which they show at the later date as compared with the earlier date (due allowance, of course, being made for any capital introduced into or taken out of the business in the meanwhile) represents in strictness the profits of the business during the period in question. But the periodical ascertainment of profits in a business is an operation of such practical importance as to be essential to the safe conduct of the business itself. To follow out the strict consequences of the legal conception in making out the accounts of the year would often be very difficult in practice. Hence the strict meaning of the word 'profit' is rarely observed in drawing up the accounts of firms or companies. These are domestic documents designed for the practical guidance of those interested, and, so long as the principle on which they are drawn up is clear, their value is diminished little, if at all, by certain departures from this strict definition which lessen greatly the difficulty of making them out. Hence certain assumptions have become so customary in drawing up Balance Sheets and Profit and Loss Accounts that it may almost be said to require special circumstances to induce parties to depart from them. For instance, it is usual to exclude gains and losses arising from causes not directly connected with the business of the company—such for instance, as a rise in the market value of land occupied by the company. The value assigned to trade buildings and plant is usually fixed according to an arbitrary rule, by which they are originally taken at their actual cost and are

assumed to have depreciated by a certain percentage each year, though it cannot be pretended that any such calculation necessarily gives their true value either in use or in exchange. These, however, are merely variations of practice by individuals. They rest on no settled principle. They mainly arise from the sound business view that it is better to underrate than to overrate the profits, since it is impossible for you to forsee all the risks to which a business may in future be exposed. For instance, there are many sound business men who would feel bound to take account of depreciation in the value of business premises (or in the value of plant specially designed for the production of a particular article), although they would not take account of appreciation in the same arising from like causes... But though there is a wide field for variation of practice in these estimations of profit this liberty ceases at once when the rights of third persons intervene... In the absence of special stipulations to the contrary 'profits' in cases where the rights of third parties come in mean actual profits, and they must be calculated as closely as possible, in accordance with the fundamental conception or definition to which I have referred."

This judgment is an extremely able appreciation of the methods usually put into practice in business circles for the ascertainment of profits. While it is true that the method adopted is not a mere single entry process, nevertheless the end is to ascertain the net gain shown by the Balance Sheet over its predecessor, after allowing for depreciation on the various assets.

This case, however, was concerned with the ascertainment of profits in which third parties are interested, and not with the question of profits available for dividend. In fact the learned judge went on to say:

"I would have it clearly understood that these remarks have no bearing upon the vexed question of the fund out of which dividends may be legally paid in limited companies. Cases such as *Verner* v. *General and Commercial Investment Trust* and *Lee* v. *Neuchatel* show that this fund may in some cases be larger than what can rightly be regarded as profits. and the decisions in these cases depend largely on the fact that there is no statutory enactment which forbids it to be so."

(2) *Re Crabtree, Thomas* v. *Crabtree* (1912, 106, L.T. 49).

A testator gave his trustees authority to carry on his business during the lifetime of his wife, and directed that the profits arising from the said business should be paid to her. The trustees, before arriving at the profits, had charged an annual sum for depreciation

of machinery at the rate of 7½ per cent. on its original value in addition to the cost of repairs, and the tenant for life contended that this ought to be disallowed. The Court of Appeal held that following Swinfen Eady, J., such depreciation had been properly charged.

In the course of his judgment Cozens-Hardy, M.R., said:

"But in the ordinary course of ascertaining the profits of a business where there is power machinery and trade machinery which is necessary in order to perform the work of the business, it is, in my opinion, essential that, in addition to all sums actually expended in repairing the machinery, or in renewing parts, that there should be also written off a proper sum for depreciation, and that sum ought to be written off before you can arrive at the net profits of the business, or at the profits of the business, and it is not profit until a proper sum, varying with the class of machinery, with the nature of the business, and the life of the machinery, has been written off for depreciation."

It must be remembered that the business concerned in the *Crabtree Case* was not carried on by a limited company.

(3) *In Edwards* v. *Saunton Hotel Co., Ltd.* (1942, T.R. 359).

Where a director of the company was entitled to 20% of the profit "available for distribution each year," a similar conclusion was arrived at with regard to depreciation of fixed assets as in *re Crabtree,* the further direction being made that the depreciation should be calculated on the fixed instalment method, and not on the reducing instalment system, which would cause a disproportionate charge to be made against profits in the early years of the life of an asset.

In *Edwards* v. *Saunton Hotel Co., Ltd.* it was also confirmed that in ascertaining the profits Income Tax should *not* be deducted, and that the commission should be computed on the profits *before* deducting the commission.

[In C.I.T. v. Delhi Flour Mills Co. Ltd. (1959) 35 I.T.R., 15] the Supreme Court of India held that the question whether excess profits tax should be deducted or not, for the purpose of computing net profits, where the commission is payable at the rate of a particular percentage of the "net profits" is one of construction of the agreement.

By an agreement made in 1936, the assessee company appoint-

ed a firm as its managing agents. The agreement provided that the managing agents would be remunerated in the manner following:

"In consideration for acting as managing agents the company should pay to the firm remuneration at Rs. 750 p.m. or such principal sum as may from time to time be deemed reasonable by the directors and in addition a commission equal to 10% of the annual net profits. Such net profits will be arrived at after allowing the working expenses, interest on loans and due depreciation, but without setting aside anything to reserves or other special funds."

Held, on the facts, that the agreement was essentially one to share the profits and that the parties to the agreement intended that the managing agents' remuneration should be commensurate with the benefit produced for the company as the result of their efforts, and, therefore, the net profits contemplated by the parties were such profits as both the company and the managing agents could enjoy in stated proportions, namely, the divisible profits of the company. In order that the divisible profits could be ascertained excess profits tax payable by the company had, of course, to be deducted, for, that part of the profits which was taken away by the State as excess profits tax was not available either to the company or to the managing agents and could not therefore be divided between them. "Net profits," therefore, meant the divisible profits and were to be ascertained after deduction of excess profits tax which was payable by the company.

Even though, the net profits for the purpose of computing managing agents' commission, are required to be determined according to Section 349, Companies Act, 1956, this decision, nevertheless, will serve as a useful guide where it is a question of construction of an agreement, under which remuneration is based on net profits.

§ 2. Divisible Profits

The legal aspect of the subject as affecting limited companies is of great importance in determining divisible profits. Section 205, Companies Act, 1956, which makes provisions in this behalf, has been radically amended by the Companies (Amendment) Act, 1960 and is reproduced hereunder:

(1) No dividend shall be declared or paid by a company for any financial year except out of the profits of the company for that year arrived at after providing for depreciation in accordance with the provisions of sub-section (2) or out of the profits of the company for any previous financial year or years arrived at after providing for depreciation in accordance with those provisions and remaining undistributed or out of both or out of moneys provided by the Central Government or a State Government for the payment of dividend in pursuance of a guarantee given by that Government:

Provided that—

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

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

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

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

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

(*a*) to the extent specified in section 350; or

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

(*c*) on any other basis approved by the Central Government which has the effect of writing off by way of depreciation ninety-five

per cent. of the original cost to the company of each such depreciable asset on the expiry of the specified period; or

(*d*) as regards any other depreciable asset for which no rate of depreciation has been laid down by the Indian Income-Tax Act, 1922 or the rules made thereunder, on such basis as may be approved by the Central Government by any general order published in the Official Gazette or by any special order in any particular case:

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

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

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

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

(5) For the purposes of this section—

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

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

Under Section 205, dividend cannot be declared or paid by a company for any financial year except:

(1) out of the profits of the company for that year arrived at *after* providing for depreciation in accordance with the provisions of Section 205(2); or

(2) out of the profits of the company for any *previous* financial year or years arrived at *after* providing for depreciation

[subject to the second proviso to Section 205(1)] and remaining undistributed; or

(3) out of the aggregate of profits mentioned in (1) and (2) above; or

(4) out of moneys provided by the Central Government or a State Government for the payment of dividend in pursuance of a guarantee given by that Government.

(A) ARREARS OF DEPRECIATION

The second proviso to Section 205(1) provides that it shall not be necessary for a company to provide for depreciation as aforesaid where a dividend for any financial year is declared out of the profits of any *previous* financial year or years falling *before* 28th December 1960. Hence the profits of the financial years ending *before* 28th December 1960 are available for distribution without making good the arrears of depreciation.

However, if the company has not provided for depreciation for any previous financial year or years falling *after* 28th December 1960, it must, before declaring dividend for any financial year, provide for such depreciation out of the profits of that financial year or of any other previous financial year or years. Thus, in respect of the years falling *after* 28th December 1960, all arrears of depreciation are required to be made good before declaring a dividend.

In short, in regard to arrears of depreciation, the legal position is as under:

(1) In respect of the current financial year the prescribed depreciation must be provided.

(2) In respect of financial years falling *before* 28th December 1960 the arrears of depreciation are not required to be made good before declaring dividend out of profits of such previous years.

(3) In respect of the years ending *after* 28th December 1960 the arrears of depreciation computed in the prescribed manner should be made good before any dividend can be declared.

(B) PAST LOSSES

If a company has incurred any loss in a previous financial year

or years falling *after* 28th December 1960, then:

(*i*) the amount of the loss; or
(*ii*) an amount which is equal to the amount provided for depreciation for that year or those years,

whichever is less, must be set off against:

(*a*) the profits of the company, after providing for the prescribed depreciation, for the year for which dividend is proposed to be declared; or
(*b*) the profits of the company for any *previous* financial year or years arrived at after providing for the prescribed depreciation; or
(*c*) the aggregate of (*a*) and (*b*) together.

The above provisions may be explained by an illustration given hereunder:

ILLUSTRATION.

Figures in lakhs of Rupees.

	1st year. (Falling after 28th December 1960)	2nd year.	3rd year.	Total.
I. Profit or loss before depreciation.	—10	— 5	+25	+10
II. Depreciation provided in the books	— 1	— 1	— 3	— 5
III. Depreciation as prescribed under Section 205. ..	(— 8)	(— 7)	(— 6)	(—21)
IV. Profit or loss after depreciation as in II.	—11	— 6	+22	+ 5
V. Profit or loss after deducting the prescribed depreciation..	—18	—12	+19	—11

Note:

		Lakhs.
A. Past Losses. (IV) ..		17
B. Depreciation previously provided. II		2
C. Arrears of Depreciation. (III-II)		
1st year	7	
2nd year .. .	6	
3rd year .	3	
		16

In the above illustration, according to the provisions mentioned above, the distributable profits will be arrived at as under:

	(*In lakhs*)
Profits of the third year as per books ..	22
Less: Arrears of depreciation *not provided* for	16
	6
Less: Amount in Note A or B whichever is less	2
Distributable profit	Rs. 4

It will be seen that the said amount of rupees four lakhs can be reconciled as under:

	(*In lakhs*)
Profit for the third year before depreciation ..	25
Less: Depreciation computed in the prescribed manner in respect of three years ..	21
Distributable profit	Rs. 4

From the above illustration, it will be clear that it is not necessary that the loss *before* depreciation in respect of previous years

falling *after* 28th December 1960 should be set off to arrive at the divisible profits. In respect of such years, the requirement is that all arrears of depreciation calculated with reference to the prescribed depreciation must be made good.

In respect of losses of the years ending *before* 28th December 1960 there is no provision requiring the company to deduct the past losses (before depreciation) in arriving at the distributable profits. Therefore, it appears that in absence of a specific provision in Section 205, requiring past losses in respect of years falling *before* 28th December 1960 to be deducted, the case law on the subject (discussed hereafter) would apply, according to which the past losses are not required to be deducted in determining the divisible profits.

In respect of years ending *after* 28th December 1960, the position stands modified, only to the extent that the past losses must be analysed into losses before depreciation and the losses arising on account of depreciation. To the extent to which the loss consists of loss arising otherwise than on account of depreciation, it appears that, it is not required to be deducted.

The position in respect of set off of past losses for determining divisible profits may be summarised as under:

(1) In respect of previous years ending *before* 28th December 1960, losses and arrears of depreciation need not be taken into account.

(2) In respect of previous years ending *after* 28th December 1960:

   (*a*) All arrears of depreciation *not provided* must be set off against the profits.

   (*b*) The losses of such years must be set off to the extent to which they consist of depreciation *provided* in the books.

(C) POWER OF CENTRAL GOVERNMENT

If the Central Government thinks it necessary so to do in the public interest, it may allow any company to declare a dividend for any financial year out of the profits of the company for that year or any previous year or years ***without providing for depreciation.***

§ 3. Depreciation

The controversy as to whether depreciation should be provided on fixed assets or not before determining divisible profits is now set at rest by the express provision in Section 205 discussed above. In regard to the quantum of depreciation to be provided for in determining the divisible profits, Section 205(2) provides that depreciation must be provided either—

(*a*) to the extent specified in Section 350; or
(*b*) in respect of each item of depreciable asset, for such an amount as is arrived at by dividing ninety-five per cent. of the original cost by the specified period; or
(*c*) on any other basis approved by the Central Government by which ninety-five per cent. of the original cost of each such depreciable asset can be written off on the expiry of the specified period; or
(*d*) in respect of an asset for which no rate of depreciation has been laid down by the Income-tax Act, or the rules made thereunder, on such basis as may be approved by the Central Government by general or special order.

(A) Depreciation under Section 350

Section 350, Companies Act, 1956, provides that—

The amount of depreciation to be deducted in pursuance of clause (k) of sub-section (4) of section 349 shall be the amount calculated with reference to the written-down value of the assets as shown by the books of the company at the end of the financial year expiring at the commencement of this Act or immediately thereafter and at the end of each subsequent financial year, at the rate specified for the assets by the Indian Income-tax Act, 1922, and the rules made thereunder for the time being in force, as normal depreciation including therein extra and multiple shift allowances but not including therein any special, initial or other depreciation or any development rebate, whether allowed by that Act or those rules or otherwise:

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

Section 350 makes provision in regard to three matters:

(*i*) the written down value which is to be adopted;
(*ii*) the method and the extent of depreciation; and
(*iii*) treatment of obsolescence allowances.

In absence of any specific provision there has arisen a difference of opinion in regard to the determination of written down valuc for the purposes of Section 350. Section 350 does not clearly state the method and the extent of depreciation to be provided to arrive at such written down value but merely prescribes the method and extent of depreciation to be provided in respect of the years ending *after* 28th December 1960.

One view is that the written down value as shown by the books as at the end of the first financial year expiring at or immediately after 1st April 1956 should be taken and normal depreciation (excluding extra and multiple shift allowances) at the Income-tax rates should be deducted each year until the notional written down value as at the end of the immediately preceding accounting year (i.e. the year ending before 28th December 1960) is arrived at. This notional written down value should be adopted for the purpose of computing depreciation in respect of the year ending *after* 28th December 1960. This view is supported by the Company Law Administration.

The other view is that in absence of any express provision in Section 350 for adopting a notional basis of written down value, there is no warrant for adopting the procedure described above. According to this view, it is not correct to adopt a notional written down value. The written down value of the immediately preceding year as per the books, whatever it may be, should be taken as the basis for computing depreciation in respect of the year ending *after* 28th December 1960.

The depreciation as per Section 350 is to be taken into account not only for determining the net profits under Section 349 but also for the purpose of calculating the arrears of depreciation under Section 205 which are required to be stated by way of a note to the Profit and Loss Account. If the written down value is computed according to the first mentioned view there would arise a difficulty in computing such arrears of depreciation. In

those cases where the notional written down value is less than that as per the books, the amount of arrears of depreciation for the purposes of Section 205 will come to a larger figure than the amount required for hundred per cent. write off of the assets. In those cases where the notional written down value is more than that as per books, such arrears will come to a lesser figure than the amount required to write off the assets fully.

In regard to the basis and the extent of depreciation to be provided in respect of years ending *after* 28th December 1960, Section 350 provides that the depreciation should be written off at the rates specified for the assets by the Income-tax Act and the rules made thereunder, for the time being in force. At such rates the company should provide normal depreciation *including* therein extra and multiple shift allowances but *excluding* any special, initial or other depreciation or any development rebate.

Where any asset is sold, discarded, demolished or destroyed in any financial year the loss (excess of written down value over its sales proceeds or scrap value) should be written off in the same financial year.

Such loss on assets is also required to be taken into account where a company has adopted alternative basis of providing for depreciation under clause (b) or clause (c) of Section 205(2).

(B) SPECIFIED PERIOD

For the purposes of Section 205, "specified period" in respect of any depreciable asset means the number of years at the end of which at least ninety-five per cent. of the original cost of that asset to the company will have been provided for by way of depreciation, if depreciation were to be calculated in accordance with the provisions of Section 350.

For example, in case of an asset costing Rs. 1,00,000, on which the prescribed rate of depreciation as per Income-tax Rules is twenty-five per cent., it will require eleven years to write off by the reducing balance method ninety-five per cent. of the original cost by way of depreciation. In such a case, the company may write off depreciation at the rate arrived at by dividing Rs. 95,000 by 11, that is, the company may write off depreciation at the rate of 8.64% on a straight line method.

§ 4. Legal Decisions

The question of divisible profits has been the subject of some notable decisions. These cases were decided on the basis of the law then obtaining and having regard to the facts of each case and hence these decisions must be taken as applying to the specific cases concerned, and in future each case must be considered having regard to the particular facts and circumstances surrounding it.

It must, however, be clearly understood, that the propositions laid down by the Courts in these cases now stand modified by reason of the amendment of Section 205, which has been discussed in detail in § 2 and 3 of this chapter.

It is proposed first of all to summarise these cases, and from the consideration thereof to draw such general conclusions as may be possible.

(A) LEGAL DECISIONS

(1) *Lee* v. *Neuchatel Asphalte Co., Ltd.,* (1889 41 Ch. 1).

Held—THAT A COMPANY, EMPOWERED TO DO SO BY ITS ARTICLES OF ASSOCIATION, MAY DISTRIBUTE DIVIDENDS WITHOUT MAKING GOOD THE DEPRECIATION OF *WASTING* ASSETS.

This action was brought by Mr. Lee on behalf of himself and all the ordinary shareholders of the Neuchatel Asphalte Company, with the object of obtaining an injunction to prevent the directors of that company from distributing a dividend to the preference shareholders until depreciation of the company's property had been provided for. The Articles of the company provided that the directors should not be bound to reserve money for the renewal or replacement of any lease, or of the company's interest in any property or concession; though as a matter of fact the company did from time to time write off considerable amounts, but had not made any such provision in the year during which the profit which it was proposed to distribute had arisen.

It may be remarked that in the case of a leasehold mine which cannot be exhausted during the term of the lease, the loss is continuous whether the mine be worked or not, and is a question of time and not of output; while in the case of a freehold mine the loss is one of output only. The learned judge in the remarks

quoted below on this point did not refer to the element of time.

Lindley, L.J., in the course of his judgment said (Acct. L. R. 1889, 26):

"The respondent company was formed for the purpose of working certain asphalte mines of which it had got a lease. It was quite obvious that with respect to such a property, every ton of stuff got out of that which was bought with capital represented a portion of capital. It was said that a division of the profit arising from the sale of such was a return of capital. If that was so, it is not, at all events, such a return of capital as is prohibited by the Company Acts. There is nothing in any of the Company Acts prohibiting anything of the kind .... It has been very judicially and properly left to the commercial world to settle how the accounts were to be kept. The Acts do not say what expenses are to be charged to Capital Account and what to Revenue Account. Such matters were left to the shareholders: they may or may not have a Sinking Fund or a Deterioration Fund, the Articles of Association may or may not contain regulations on these matters, if they do, the regulations must be observed; if they do not, the shareholders can do as they like so long as they do not misapply their capital. In this case one of the Articles provides that the directors shall not be bound to reserve moneys for the renewal or replacing of any lease or of the company's interest in any property or concession .... Now, the Companies Act, 1862, does not require the capital to be made up if lost, and it does not prohibit payment of dividends so long as the assets are of less value than the capital called up, nor does it make loss of capital a ground for winding-up. But if a company is formed to acquire or work property of a wasting nature, *e.g.*, a mine, quarry, or patent, the capital expended in acquiring the property may be regarded as sunk and gone, and if the company retains assets sufficient to pay its debts, any excess of money obtained by working the property over the cost of working it may be divided amongst the shareholders; and this is true, although some portion of the property itself is sold, and in one sense the capital is thereby diminished. If it is said that such a course involves payment of dividends out of capital, the answer is that the Acts nowhere prohibit such a payment as is here supposed. The proposition that it is *ultra vires* to pay dividends out of capital is very apt to mislead, and must not be understood in such a way as to prohibit honest tradings. It is not true, as an abstract proposition, that no dividends can be properly declared out of moneys arising from the sale of property bought by capital. But it is true that if the working expenses exceed the current gains, profits cannot be divided, and that if in such a case capital is divided and paid away as dividend, the capital is misapplied, and the directors implicated in the misapplication may be compelled to make good the amount misapplied ...."

(2) *Bolton* v. *Natal Land and Colonisation Co., Ltd.*, (1892 2 Ch. 124).

Held—THAT A COMPANY MAY DECLARE A DIVIDEND OUT OF CURRENT PROFITS WITHOUT NECESSARILY MAKING GOOD LOSS OF CAPITAL.

The Natal Land Company, in 1882, had charged against revenue £70,000 in respect of a bad debt which had been incurred, and, at the same time, adjusted the Profit and Loss Account by crediting to it practically the same sum in respect of an increase in value attributed to lands held by them.

In 1885 a profit was made and a dividend subsequently declared, and the plaintiff thereupon brought this action for restraining the payment of the dividend. His argument was that the value of the land in the books was now in excess of the true value, and that the difference between the 1882 book value and the actual value should be written off against profits before anything could be appropriated for the purposes of dividend.

The Court held that, assuming a part of the capital had in fact been lost, and not subsequently made good, no sufficient ground was thereby afforded for restraining the payment of the dividend; that the fact of the company having written up the value of the land in 1882, and credited the increase to the profit of that year in the manner described, did not place it under any obligation to bring into account in every subsequent year the increase or decrease in the value of its lands; and that, having regard to the case of *Lee* v. *Neuchatel Asphalte Company, Limited,* it was not correct, in estimating the profits of a year, to take into account the increase or decrease in the value of the capital assets of the company.

It might appear that this case supported the suggestion that a company might write up the value of its capital assets to conceal a revenue loss without being obliged to charge against revenue any decrease subsequently found to have occurred owing to excessive appreciation in the past; but it should be remembered that the Court did not have before it the question as to whether the bad debt should have been charged against revenue or not, the learned judge specifically stating that this point was not raised on the pleadings.

(3) *Verner* v. *General and Commercial Investment Trust, Ltd.,* (1894 2 Ch. 239).

Held—THAT, SUBJECT TO ITS ARTICLES, A TRUST COMPANY MAY DISTRIBUTE A DIVIDEND OUT OF THE EXCESS OF CURRENT INCOME OVER CURRENT EXPENDITURE, WITHOUT MAKING GOOD LOSS OF CAPITAL.

This trust company had issued share capital to the extent of £600,000, and had borrowed £300,000 on the security of debenture stock. The proceeds of these issues had been invested in various securities authorised by the Memorandum of Association. The market value of such securities at the date of the account was £654,776, depreciation having thus occurred to the extent of about £240,000, of which it was estimated that about £75,000 represented an amount which there was no prospect of recovering within any reasonable period of time. During the company's last financial year the current income from investments had exceeded the current expenditure by more than £23,000, and the question for the Court to decide was whether such excess could be utilised for the purposes of dividend without taking into account the loss of capital to the amount of £75,000.

Lindley, L.J., in the course of his judgment, said:

"The broad question raised by this appeal is whether a limited company which has lost part of its capital, can lawfully declare or pay a dividend without first making good the capital which has been lost. I have no doubt it can—that is to say, there is no law which prevents it in all cases and under all circumstances. Such a proceeding may sometimes be very imprudent, but a proceeding may be perfectly legal and may yet be opposed to sound commercial principles. We, however, have only to consider the legality or illegality of what is complained of .... There is no law which prevents a company from sinking its capital in the purchase or production of a money-making property or undertaking, and in dividing the money annually yielded by it without preserving the capital sunk so as to be able to reproduce it intact, either before or after the winding-up of the company. A company may be formed upon the principle that no dividends shall be declared unless the capital is kept undiminished, or a company may contract with its creditors to keep its capital or assets up to a given value. But in the absence of some special Article or contract there is no law to this effect, and, in my opinion, for very good reasons. It would, in my judgment be most inexpedient to lay down a hard-and-fast rule which would prevent a flourishing company either not in debt or well able to pay its debts from paying dividends, so long as its capital sunk in creating the business was not represented by assets

which would, if sold, reproduce in money the capital sunk. Even a sinking fund to replace lost capital by degrees is not required by law... But, although there is nothing in the statutes requiring even a limited company to keep up its capital, and there is no prohibition against payment of dividends out of any other of the company's assets, it does not follow that dividends may be lawfully paid out of other assets, regardless of the debts and liabilities of the company. A dividend presupposes a profit in some shape, and to divide as dividend the receipts, say, for a year, without deducting the expenses incurred in that year in producing the receipts, would be as unjustifiable in point of law as it would be reckless and blameworthy in the eyes of business men. The same observation applies to the payment of dividends out of borrowed money. Further, if the income of any year arises from a consumption in that year of what may be called circulating capital, the division of such income as dividend without replacing the capital consumed in producing it will be a payment of a dividend out of capital within the meaning of the prohibition which I have endeavoured to explain... Perhaps the shortest way of expressing the distinction which I am endeavouring to explain is to say that fixed capital may be sunk and lost, and yet that the excess of current receipts over current payments may be divided, but that floating or circulating capital must be kept up, as otherwise it will enter into and form part of such excess, in which case, to divide such excess without deducting the capital which forms part of it, will be contrary to law... "

(4) *Wilmer* v. *McNamara & Co., Ltd.*, (1895 2 Ch. 245).

Held—THAT A COMPANY CAN DECLARE A DIVIDEND OUT OF CURRENT PROFITS, WITHOUT MAKING GOOD DEPRECIATION OF FIXED ASSETS.

This company made a profit for the year ended 30th June 1894 of £5,816 12s. 6d., before making any provision for depreciation in respect of the value of the leases, goodwill, or plant. Depreciation had been provided on these assets to a considerable extent in earlier years, but no provision was made during the year in question. A resolution was passed by the company to distribute the above-mentioned profit in payment of a dividend to the preference shareholders. This action was taken on behalf of the ordinary shareholders to restrain the directors from giving effect to the resolution, on the ground that until the loss of capital had been made good no dividends ought to be paid.

Stirling, J., in the course of his judgment, refusing the injunction asked for, said:

"Clause 117 of the company's Articles of Association provides that 'no dividend shall be payable except out of the profits arising out of the business of the company.' What are these profits? .... Apart from the use of the word 'profits' in clause 117, there is nothing in the Articles to show that the capital of the company (or, rather, assets of the value of those acquired by the company at its formation) must be kept up. Further, the Articles appear to contemplate 'profits' as the excess of receipts over all expenditure properly attributable to the year. It is necessary, however, to consider whether the depreciation in goodwill and leaseholds is to be treated as loss of 'fixed' capital or of 'floating' or 'circulating' capital, and on this point I am of opinion that it is to be treated as loss of 'fixed' capital. It very closely resembles the loss which a railway company may be said to suffer if it be found that their line, which was made, say, ten years ago at a certain cost, could now be made at a much smaller cost. Having regard to the remarks of Lindley, L.J., in *Lee* v. *Neuchatel Asphalte Company* (*supra*) I think that the Balance Sheet cannot be impeached simply because it does not charge anything against revenue in respect of goodwill. I feel much more doubt whether £200 is a sufficient sum to allow in respect of depreciation of leaseholds, but I do not think under the circumstances that a case has been made out for an injunction."

(5) *Dovey* v. *Cory* (*National Bank of Wales case,* 1901 A.C. 477).

Held—THAT A DIRECTOR, IF HE ACTS BONA FIDE IS ENTITLED TO RELY ON THE OFFICERS OF THE COMPANY TO PREPARE TRUE AND HONEST ACCOUNTS.

This was an appeal from the decision of the Court of Appeal. It was sought to make the director liable in respect of alleged misfeasance for paying dividends out of capital.

Wright, J., had ordered the respondent to pay £54,787, being £37,000, the aggregate amount of dividends paid to the shareholders in 1887, 1888, 1889, and part of the dividend of 1890, and as to the balance, interest at 5 per cent. per annum on each of the dividends, holding that these dividends were in fact paid out of capital. Such dividends had been paid without making proper provision for bad debts; had these bad debts been written off there would have been no profits available for dividend. The Court of Appeal relieved the respondent of liability on the ground that he had been deceived by persons he was entitled to trust, and that the dividends were not in fact paid out of capital; utilising

for the latter point the arguments advanced in the *Lee* v. *Neuchatel* series of cases.

The House of Lords decided the case purely on the question as to whether the director concerned was or was not justified in reposing confidence in the officials of the company, and did not feel themselves called upon to deal with the question as to whether the dividends had or had not in fact been paid out of capital.

Although, however, the House of Lords did not actually give their decision on this point, remarks were made by the Lord Chancellor (Lord Halsbury) and Davey, L.J., in the course of their judgements, which clearly showed that they were not at all inclined to agree with the deductions drawn in the Court of Appeal from the *Lee* v. *Neuchatel* and other cases; and consequently doubts have been cast upon the finality of those decisions.

The Lord Chancellor said:

"If I assume, as I do, that Mr. Cory acted upon representations made to him which he believed, and which as coming from the officers of the bank to whom he was, in my judgment, justified in giving credit, the discussion of whether the dividends actually paid were or were not properly divisible, has no bearing on Mr. Cory's liability, and I am very reluctant to give any opinion upon it, inasmuch as the question may arise when it may be necessary to decide it. I deprecate any premature judgment. My Lords, I am, as I have said, very reluctant to enter into a question which for the reasons I have given does not arise here, and into which the Court of Appeal has entered at some length. The only reason why I refer to it at all, is lest by silence I should be supposed to adopt a course of reasoning as to which I am not satisfied that it is correct. I doubt very much whether such questions can ever be treated in the abstract at all. The mode and manner in which a business is carried on, and what is usual or the reverse, may have a considerable influence in determining the question what may be treated as profits and what is capital. Even the distinction between fixed and floating capital, which in an abstract treatise like Adam Smith's 'Wealth of Nations' is appropriate enough, may with reference to a concrete case be quite inappropriate. It is easy to lay down as an abstract proposition that you must not pay dividends out of capital, but the application of that very plain proposition may raise questions of the utmost difficulty in their solution.... On the one hand, people put their money into a trading concern to give them an income, and the sudden stoppage of all dividends would send down the value of their shares to zero, and possibly involve its ruin. On the other hand, companies cannot at their will and without the precautions enforced by the statute reduce their capital; but what are profits and what is capital may be a difficult and sometimes an almost impossible problem to solve. When the time comes that these questions come before us in a concrete case we

must deal with them, but until they do, I, for one, decline to express an opinion not called for by the particular facts before us, and I am the more averse to doing so because I forsee that many matters will have to be considered by men of business which are not altogether familiar to a Court of Law."

Davey, L.J., said:

"I desire to express my dissent from some propositions of law which were laid down in the Court of Appeal, and upon which your Lordships thought it right to hear the respondent's counsel. The learned Judges seem to have thought that a joint stock company, incorporated under the Companies Acts, may write off to capital, losses incurred in previous years, and may in any subsequent year, if the receipts for that year exceed the outgoings, pay dividends out of such excess without making up the Capital Account. If this proposition be well founded it appears to me that a company whose capital is not represented by available assets need never trouble itself to reduce its capital, with the leave of the Court and subject to the other conditions imposed by the Act of 1877, in order to enable itself to pay dividends out of current receipts. My Lords, it may be that I have misapprehended the statement of law intended to be made by the learned Judges in the Court of Appeal. I think that is possible, because I find that in *Verner* v. *General and Commercial Investment Trust* (1894, 2 Ch. 124), 'Perhaps,' Lord Lindley says, 'the shortest way of expressing the distinction which I am endeavouring to explain is to say that fixed capital may be sunk or lost, and yet that the excess of current receipts over current payments may be divided, but that floating or circulating capital must be kept up, as otherwise it will enter into and form part of such excess, in which case to divide such excess without deducting the capital which forms part of it will be contrary to law.' I reserve my opinion as to the effect of an actual and ascertained loss of part of the company's fixed capital.... But, subject to this observation, I think that the statement of law in the passage I have quoted is not open to objection, and it is only because the learned Judge appears to me to have departed from it in his judgment in the present case that I have troubled your Lordships with these remarks."

(6) *Bond* v. *Barrow Hæmatite Steel Co., Ltd.*, (1902 1 Ch. 353).

Held—THAT WHERE THE ARTICLES GIVE POWER TO PUT TO RESERVE BEFORE THE PAYMENT OF A DIVIDEND, PREFERENCE SHAREHOLDERS CANNOT COMPEL DIRECTORS TO DECLARE A DIVIDEND WITHOUT MAKING SUCH RESERVES AS THEY CONSIDER NECESSARY.

The Profit and Loss Account of this company for the year 1900 showed a balance of £157,605 12s. 11d., which was pro-

visionally carried forward. No depreciation had been written off land, buildings, works, fixed plant, and mining leases for some years, and on a revaluation being made it appeared that a considerable loss had been sustained, and application was made to the Court for reduction of capital. This was dismissed on the ground that the alleged loss was not proved to the satisfaction of the Court, and an action was subsequently taken by certain preference shareholders to compel the company to pay their dividends out of the credit balance on Profit and Loss Account, without making good the loss stated to have been sustained.

Farwell, J., gave judgment for the company, on the ground that the preference shareholders could not compel directors to declare a dividend without making such reserves as they considered necessary, but he added some further remarks on the question of the application of the *Lee* v. *Neuchatel* series of cases, which are of some importance.

He said:

"It has been proved to my satisfaction...that the company has sustained an actual ascertained and realised loss of capital to an amount exceeding £200,000, and has also lost capital by estimate and valuation to an amount exceeding £50,000. The various sums claimed by the plaintiffs as available to pay their dividends amount to about £240,000. If, therefore, these ascertained and estimated losses have to be made good before any dividend can properly be paid, there are obviously no funds out of which to pay dividends. The defendants allege and the plaintiffs deny that the company are bound to make good these losses before paying any dividend. The question is one of very considerable difficulty on the authorities, but the result of these authorities is, in my opinion, that there is no hard-and-fast rule by which the Court can determine what is capital and what is profit.... The real question for determination, therefore, is whether there are profits available for distribution, and this is to be answered according to the circumstances of each particular case, the nature of the company, and the evidence of competent witnesses.... Now in the present case the £200,000 realised loss arises by the surrender of the leases of certain mines, by the pulling down of certain furnaces, and on the sale of certain cottages. The company is a smelting company on a very large scale, and for the convenience of its works and by way of economy they acquired the leases of the surrendered mines in order to supply themselves with their own ore instead of buying it as required. The ore was used exclusively for the purposes of the company's works. The mines were drowned out and the cost of pumping them out was prohibitive. The company, therefore, surrendered the leases, pulled down the blast furnaces,

and sold the cottages connected therewith. Now the evidence before me is all on one side. The plaintiffs called none, and Sir David Dale and the defendants' other witnesses all agree that in a company of this nature these items ought to come into the account before any profit can be said to be earned, and my own opinion coincides with theirs, inasmuch as I think that the money invested in those items is properly regarded in this company as circulating capital. Suppose the company had bought enormous stocks of ore sufficient to last for ten years, it could hardly be said that the true value of so much of this as remained from time to time ought not to be brought into the Balance Sheet, and I can see no difference for the purpose of the account between ore *in situ* and ore so bought in advance. The blast furnaces and cottages are mere accessories to the ore, and resemble a building for burning the stores bought in advance already mentioned. There is more difficulty about the remaining £50,000. I think that the onus is on the plaintiff to show that it is fixed capital, and that in a company of this nature such fixed capital may be sunk or lost. They have not done this, and the evidence, so far as it goes, is the other way. But this is not an actual loss, but depreciation by estimate. The plaintiffs really relied on *Lee* v. *Neuchatel Asphalte Company* as an authority for this proposition as a universal negative—viz., 'that no company owning wasting property need ever create a depreciation fund.' In my opinion that is not the true result of the decision. It must be remembered that in that case there had been no loss of assets. The company's assets were larger than at its formation, and the Court decided nothing more than the particular proposition that some companies with wasting assets need have no depreciation fund. For instance, I cannot think that it would be right for the defendant company to purchase out of capital the last two or three years of a valuable patent and distribute the whole of the receipts in respect thereof as profits, without replacing the capital expended in purchase. It is for the Court to determine in each case on evidence whether the particular company, ought or ought not, to have such a fund. There is no doubt as to the opinion of the witnesses in this case, and further, the opinion of the directors cannot be altogether disregarded. The Courts have, no doubt in many cases, overruled directors who proposed to pay dividends, but I am not aware of any case in which the Court has compelled them to pay when they have expressed their opinion that the state of the accounts does not admit of any such payment. In a matter depending on evidence and expert opinion it would be a very strong measure for the Court to override the directors in such a manner."

(7) *Ammonia Soda Co.* v. *Chamberlain* (1918 1 Ch. 266).

Held—THAT IT IS NOT NECESSARILY ILLEGAL FOR DIRECTORS OF A COMPANY TO PAY DIVIDENDS OUT OF THE PROFITS OF THE COMPANY DURING A CURRENT YEAR WITHOUT MAKING GOOD EXISTING DEFICIENCIES IN PAID-UP CAPITAL, OR WITHOUT WRITING OFF A

DEBIT TO THE COMPANY'S PROFIT AND LOSS ACCOUNT, OCCASIONED BY LOSSES IN PREVIOUS YEARS.

The Profit and Loss Account of this company in the year 1911 showed a debit balance of £19,028. This amount arose by debiting to that account at a time when the company's gross trading profit was insufficient to provide for the purpose certain sums for depreciation of buildings, plant and machinery, and also far directors' fees and mortgage and debenture interest.

In 1908, a boring made by the company to reach water for use in the company's works, failed in that purpose, but showed a new bed of rocksalt of which the existence was previously unknown. This discovery was considered to increase the value of the company's property, and the directors obtained a report from two of their number which advised that their land should be valued at the increased figure of £79,166, and its value was raised in the Balance Sheet of 31st July 1911, from £63,246 to £83,788 by the addition of a sum of £20,542. This sum was credited to a Reserve Account and used to cancel £12,990 of the debit of £19,028 on the Profit and Loss Account, the remainder being written off out of net profits. For the thirteen months ended 31st January 1912, the net profit made by the company was £13,030, and for the twelve months ended 31st January 1913, £15,669. From September 1912, to April 1915, dividends amounting to £13,116 were paid on the preference shares of the company. In-so-far as these dividends were paid before providing for the £12,990, the proportion of the debit balance on the Profit and Loss Account referred to above, it was claimed that they were paid out of capital and that the directors were liable to repay them. The Court of Appeal held that the revaluation of the property was *bona fide* and that the directors were not liable to refund any of the dividends. The facts were not, in any way, concealed from the shareholders, and the treatment adopted had been clearly drawn to their attention by the auditors in their report.

In the course of his judgment, Swinfen Eady, L.J., said:

"The plaintiffs contend that, although net profits were earned during the period they were not available for dividend, and cannot really be considered 'profits,' as in the earlier period of the company's history, a

loss had been incurred, and they contend that until such loss has been first made good there cannot be any profits in the real true sense of the word. In my judgment, this argument is unsound and has been exposed again and again. The Companies Acts do not impose any obligation upon a limited company nor does the law require it, that it shall not distribute as dividend the clear net profit of its trading unless its paid-up capital is intact, or until it has made good all losses incurred in previous years... Counsel for the appellants invited the Court to lay down that wherever there was a debit to the Profit and Loss Account, irrespective of the way in which it arose, of the stage in the company's operations, and of the nature and business of the company, it was illegal to divide profits subsequently earned without first writing off out of those profits the amount of the debit. To do so would be to fall into the error which Lord Macnaghten pointed out should be avoided, and would only serve to harass and embarrass business men, and impose upon companies a burden which Parliament has abstained from casting upon them. The directors in this case were of opinion that no capital had been really lost, and they were of opinion that the value of the land and works as a going concern had been increased, as a result of their boring and exploratory work, to a considerably greater amount than £19,028.... The result of increasing the value at which the land stood was to give a credit which would have enabled the debit of £19,028 to be written off. Part of it was, however, actually written off out of subsequent net profits. Now, the debit consisted in part of a nominal depreciation in the fixed assets of the company, buildings, plant and machinery, and as regards the balance, it consisted of sums paid out of the subscribed capital of the company for mortgage and debenture interest, and directors' fees, there not being sufficient trading profits to provide these amounts. The transaction was carried out with the full approval of the shareholders in general meeting, and in all honesty and good faith. The dividends complained of, paid out of net earnings in the subsequent years, were not paid out of capital, but out of profits, and the defendants are, in my opinion, under no liability whatever to repay the same, or any part...."

Warrington, L.J., said:

"There is, however, one accepted restriction on the powers of companies incorporated under the Companies Acts, namely, that they must not, under the guise of dividends or in any other way, return to their shareholders money subscribed for their shares, unless it be with the sanction of the Court under the appropriate statutory provisions. It has been asserted in this case, not for the first time, that there is a further restriction —suggested to be a corollary of the rule I have just mentioned—which would make it illegal for a company to pay dividends out of the profits of a current year, unless it first makes good deficiencies in paid-up capital occasioned by losses in previous years; or, to put the contention in a broader form, no dividends can properly be paid out of profits so long as there are losses previously incurred and not made good. In my opinion

this alleged restriction has no foundation in law.... I am, of course, far from saying that in all such cases dividends can properly be paid without making good the previous loss; the nature of the business and the amount of the loss may be such that no honest and reasonable man of business would think of paying dividends without providing for it. In such a case, I apprehend the Court would take the view that a payment which no honest and reasonable man of business would think it right to make could not properly be made by directors."

(8) *Stapley* v. *Read Bros. Ltd.* (1924-40, T.L.R. 442).

Held—THAT A COMPANY IS NOT PRECLUDED FROM PAYING DIVIDENDS OUT OF CURRENT PROFITS WHERE A DEBIT BALANCE ON PROFIT AND LOSS ACCOUNT HAS BEEN WRITTEN OFF BY THE RESTORATION OF GOODWILL AS AN ASSET AT AN AGREED FAIR VALUE, GOODWILL HAVING PREVIOUSLY BEEN COMPLETELY WRITTEN OFF OUT OF PROFITS.

In 1918 the company wrote off the balance of Goodwill Account which was then standing at £51,000, against a Reserve Account which had been built up out of profits. In 1921 and 1922 there were losses resulting in a debit balance on Profit and Loss Account of £25,500.

In 1923 a profit of £13,430 was made, but this was not sufficient to pay the dividend on the preference shares for 1923, and the arrears for 1921 and 1922. The directors proposed to redebit Goodwill Account with £40,000 on the ground that this was a conservative value to be placed on goodwill, and to credit this sum to a Reserve Account. The Reserve Account was then to be utilised for writing off the debit balance of £25,500 on Profit and Loss Account, the remainder, with the profit for 1923, to be used for payment of the dividends on the preference shares.

A shareholder thereupon applied for an injunction to restrain the directors from treating as profits available for distribution any profits previously used for writing down the company's assets and subsequently written back.

In the course of his judgment, Russell, J., said:

"... If they had retained goodwill as an asset in their balance sheet, and if, instead of writing off its value out of profits, they had carried those profits to a goodwill depreciation reserve fund, they would have been at liberty at any time to distribute those profits, at all events to the extent by which the amount of such a reserve fund exceeded the amount of the actual depreciation ...

"Does it make any difference that they have kept their account in another form, and that, instead of placing the profits to a reserve account, they have purported to apply them in writing off a corresponding amount of the value of the goodwill? The answer seems to me to depend upon the further question: Have the company finally and irrevocably capitalised those profits so as to disentitle themselves for ever afterwards from restoring them to reserve and from dealing with them as profits? No doubt the accounts showing the particular methods adopted were approved every year by the shareholders in general meeting; but I am not satisfied that the shareholders thereby intended, or bound themselves, for all time and in all circumstances to give up their claims to these profits and to treat them as capital only.

"In my opinion, unless there is anything in the Companies (Consolidation) Act, 1908, or in the constitution of the company to prohibit it, the shareholders may, if they think fit, write back to profit account so much of the depreciation written off goodwill as has proved to have been in excess of proper requirements."

(B) LEGAL DECISIONS CONSIDERED

In the *Verner* case, Lindley, L.J., made some important remarks on the distinction between "fixed" and "current" assets, when he said that "fixed" capital might be sunk and lost, and yet the excess of current receipts over current payments might be divided, but that "floating" or "circulating" capital must be kept up, as otherwise it will enter into and form part of such excess, in which case, to divide such excess without deducting the capital which forms part of it, would be contrary to law.

The terms "fixed" and "floating" or ("circulating") capital here used are equivalent to that portion of the capital represented by "fixed" and "current" assets respectively.

In regard to depreciation, under Section 205, it is obligatory to provide for current depreciation and specified arrears of depreciation before distributing dividend. However, the *Verner* case presents a slightly different problem—as to whether it is necessary to provide for depreciation on the investments of a Trust company which are fixed assets.

From the *dicta* of Lindley, L.J., in both the *Neuchatel* and *Verner* cases it is clear that the Court will protect the interests of creditors and will require that before paying dividend sufficient assets must be retained to pay the company's debts and liabilities. Earlier it has been noted that under Section 205 there is no obligation to make good past losses (before depreciation) for arriv-

ing at the divisible profits but it is a matter for consideration what view the Court will take in case such non-deductible past losses exceed the capital. To declare a dividend in such a set of circumstances, it appears, may amount to payment of a dividend in fraud of creditors. The auditor should advise the directors against distribution of dividend in such circumstances and if they still insist on it, he must state the facts clearly in his report to the members.

In the *Verner* case, Lindley, L.J., said that although a proceeding might be prefectly legal, it might be opposed to sound commercial principles, but that the Court had only to consider the legality or illegality of the company's action. This important dictum should be regarded as applicable while interpreting Section 205.

In *Ammonia Soda Co.* v. *Chamberlain* (*supra*), the Court of Appeal took the view that it was not in all cases necessary to make good a debit balance on the Profit and Loss Account before paying dividends out of current profits, but regard must be had to the way in which such debit balance had been arrived at, the nature of the company's operations, and to all the facts of the case. The circumstances in which the dividend is paid must not be such that no honest and reasonable man of business would think it right to make the distribution. The payment of dividends out of current profits without making good prior losses is not necessarily a payment of dividends out of capital.

The decision in *Stapley* v. *Read Bros. Ltd.* followed the *Ammonia Soda Co.* case in determining that dividends might be paid out of current profits, although the debit balance on the Profit and Loss Account had not been made good out of subsequent profits.

Russell, J., held that profits which had been utilised to write off goodwill in the first instance had not become irrevocably capitalised; that the company could place a proper valuation upon the existing goodwill and re-debit the account with that value, crediting the Reserve Account, and that such reserve could be utilised so far as might be necessary to write off the existing debit balance on Profit and Loss Account or for distribution as profits available for the payment of dividends.

It is apparent, however, that this course would only be permit-

ted where the assets concerned had been previously written off or written down out of divisible profits to a figure below their true value.

Under Section 205 [as discussed in § 2, Para (B) supra], the past losses before depreciation, whether arising before or after 28th December 1960, are not to be taken into account in determining the divisible profits.

In *Bond* v. *Barrow Haematite Steel Company* (*supra*), the company had sustained an actual ascertained and realised loss exceeding £200,000, and a further estimated loss exceeding £50,000. Had these losses been written off no dividend could have been paid.

Farwell, J., said that the question was one of very considerable difficulty on the authorities, but in his opinion the result of these authorities was that there was no hard-and-fast rule by which the Court could determine what is capital and what is profit. The loss in this case arose in connection with certain assets which had been acquired in order to enable the company to produce its own ore instead of purchasing ore in the market, and the Judge expressed the view that such expenditure was equivalent to expenditure on large stocks of ore bought in advance, and as such, any loss arising thereon should be treated as a loss of circulating capital, which ought to be made good before paying a dividend. It is apparent, therefore, that the classification of assets in any particular case as between "fixed" and "current" is a question of fact which will be decided by the Court, having regard to all the circumstances, and to the opinions of experts and business men, and further that the Courts are strongly disinclined to lay down any general rule on the subject.

As regards the fixed assets, the decision of the Scottish Courts in *Cox* v. *Edinburgh & District Tramways Co.* (Glasgow Herald, 17 June 1898) may be noted. The company had incurred a heavy loss in converting their system from horse to mechanical traction, and the Court held that such a loss need not be made good before the payment of a dividend, on the ground that it might be assumed that the additional expenditure enhanced the value of the undertaking as a whole.

Having regard to the fact that the legal decisions which have been given on the question of divisible profits depend to a very

large extent on the circumstances of each particular case, it is somewhat hazardous to attempt to lay down in general terms any definition of divisible profits. From the auditor's point of view, however, it is desirable that some general rule should be formulated. Subject, therefore, to the provisions of Section 205, to the qualifications above mentioned and to the Memorandum and Articles of the company concerned, the divisible profits of a company may be said to be—

(1) The excess of current income over current expenditure after making good depreciation of current assets as well as fixed assets (as provided in Sections 205 and 350) and retaining sufficient funds to pay liabilities, but without necessarily taking into account arrears of depreciation of fixed assets in respect of the years ending before 28th December 1960.
(2) Capital profits may be divisible if they are realised and a surplus remains after making good any capital losses, and if it is within the powers of the company to distribute such capital profits (as discussed infra in § 5 of this chapter).
(3) Revenue losses must be made good before revenue profits can be distributed, and capital losses must be made good before capital profits can be distributed; but capital losses need not necessarily be made good before revenue profits are distributed.
(4) It is not, however, necessary to make good existing deficiencies in paid-up capital or write off of a debit on the company's Profit and Loss Account occasioned by losses (before depreciation) in previous years but in such cases it should be seen that sufficient funds are retained to pay the liabilities of the company.

The auditor should, therefore, consider each case in practice according to the circumstances. In all cases, where no provision is made for depreciation, the fact that no provision has been made should be stated in the Profit and Loss Account and the quantum of arrears of depreciation computed in accordance with Section 205 of the Act should be disclosed by way of a note. Where the dividend is proposed in contravention of the provisions of Section 205, the auditor should draw the attention of the directors

and the members to this point.

§ 5. Capital Profits

The question as to whether *capital* profits are available for the payment of dividends, and if so, under what circumstances, is a particularly important one, and there have been two cases decided which will now be summarised, and from which it will be possible to draw some general conclusions.

(A) LEGAL DECISIONS

(1) *Lubbock* v. *The British Bank of South America,* (1892 2 Ch. 198).

Held—THAT A PROFIT MADE ON THE SALE OF A PART OF THE UNDERTAKING OF A COMPANY IS AVAILABLE FOR DIVIDEND, IF THE ARTICLES SO PERMIT.

This company, under the name of the English Bank of Rio de Janeiro, had sold to another bank its goodwill and property in Brazil for a sum of £875,000, agreeing, upon the payment of that sum, to discontinue the use of its name, and to adopt a name not indicating a bank doing business in Brazil, and also contracting to refrain from carrying on business in Brazil. Subsequently this restraint was released on payment by the defendant bank of £75,000; and the £205,000 which it was proposed to distribute consisted of the original consideration for the Brazilian business, less the paid-up capital of the company (£500,000), together with the £75,000 referred to above, and sundry other payments, for outgoings and compensations in reference to the sale of the Brazilian Bank.

Chitty, J., held that the £205,000 was plainly profit on capital, and not part of the capital itself, for that sum was the surplus ascertained after the liabilities and capital were placed on one side of of the account and the assets on the other. Under the Articles of the company the directors were justified in carrying over the £205,000 to the Profit and Loss Account; and having appropriated to the Reserve Fund so much of the sum as they thought fit, they could distribute the remainder as dividends after an ordinary meeting, called in pursuance of the Articles, had passed the requisite resolution.

(2) *Foster* v. *The New Trinidad Lake Asphalte Company, Ltd.*, (1901 1 Ch. 208).

Held—THAT A REALISED APPRECIATION IN THE VALUE OF A BOOK DEBIT TAKEN OVER BY A COMPANY AT ITS FORMATION IS NOT PROFIT AVAILABLE FOR DIVIDEND, UNLESS SUCH SURPLUS REMAINS AFTER A REVALUATION OF THE WHOLE OF THE ASSETS.

This company at its formation had taken over amongst other assets a debt of $ 100,000, secured by promissory notes. This debt was not then regarded as of any value, but subsequently it was paid in full, together with interest accrued, realising £26,258 16s. As no value was placed on this asset in the company's books, the amount received was treated as a profit, and it was proposed by the directors to regard it as available for dividend, and to distribute it accordingly, without taking into account any decrease in the value of other assets.

Byrne, J., in the course of his judgment *restraining the distribution,* said:

"It appears to me that the amount in question is *prima facie* capital and that I have no evidence which would justify me in saying that it has changed its character because it has turned out to be of greater value than had been expected.... I must not, however, be understood as determining that this sum or a portion of it may not properly be brought into Profit and Loss Account or be taken into account in ascertaining the amount available for dividend. That appears to me to depend upon the result of the whole account for the year. It is clear, I think, that an appreciation in total value of capital assets, if duly realised by sale or getting in of some portion of such assets, may in a proper case be treated as available for purposes of dividend. This, I think, is involved in the decision in the case of *Lubbock* v. *British Bank of South America* (1892 2 Ch. 198), cited with approval by Lord Lindley in *Verner* v. *General and Commercial Investment Trust* (1894 2 Ch. 239, at page 265), where he says: 'Moreover, when it is said and said truly, that dividends are not to be paid out of capital the word "capital" means the money subscribed pursuant to the Memorandum of Association, or what is represented by that money. Accretions to that capital may be realised and turned into money, which may be divided amongst the shareholders, as was decided in *Lubbock* v. *British Bank of South America.*' If I rightly appreciate the true effect of the decisions, the question of what is profit available for dividend depends upon the result of the whole accounts fairly taken for the year, capital, as well as profit and loss, and although dividends may be paid out of earned profits, in proper cases, although there has been a

depreciation of capital, I do not think that a realised accretion to the estimated value of one item of the capital assets can be deemed to be profit divisible amongst the shareholders without reference to the result of the whole accounts fairly taken."

(B) LEGAL DECISIONS CONSIDERED

From a consideration of the above cases taken in conjunction with one another, it may be said that capital profits are not available for dividend unless:

(1) The Articles of Association permit such distribution;
(2) The surplus is *realised;* and
(3) Such surplus *remains* after a proper valuation of the *whole* of the assets has been fairly taken.

In the *New Trinidad* case the company were not apparently prepared to revalue the whole of their assets; had they been willing to do so, and had they been able to prove to the satisfaction of the Court that a capital profit was finally shown, there is no doubt but that the Court would have permitted such a profit to be disributed in dividend.

Where expenditure of a capital nature has been charged to revenue, a company can subsequently reimburse revenue out of capital; and the same procedure can be followed where an estimated loss on Capital Account has been charged to revenue, but the assets have subsequently appreciated in value [*Mills* v. *Northern Rly. of Buenos Ayres Co.,* 1870 5 Ch. 621; *Bishop* v. *Smyrna and Cassaba Rly. Co.* (No. 2), 1895 2 Ch. 596].

Capital profit arising on a *bona fide* revaluation of fixed assets can be utilised to write off a debit balance on the Profit and Loss Account arising in prior periods, thus enabling dividends to be paid out of current profits (*Ammonia Soda Co.* v. *Chamberlain, supra*).

§ 6. Dividends

The divisible profits of a company having been considered, there remain a number of points which require to be dealt with in connection with the declaration and payment of dividends.

(A) PAYMENT OF DIVIDENDS

Section 205(3) provides that no dividend shall be payable except in cash. However, this provision shall not be deemed to

prohibit the capitalisation of profits or reserves of a company for:

(*i*) the purpose of issuing fully paid-up bonus shares; or

(*ii*) paying up any amount for the time being unpaid on any shares held by the members of the company.

Section 205(5)(b) provides that any dividend payable in cash may be paid by cheque or warrant sent through the post directed to:

(*i*) the registered address of the shareholder entitled to dividend; or

(*ii*) in the case of joint shareholders, to the registered address of the joint shareholder first named on the register of members; or

(*iii*) such persons and to such address as the shareholder or the joint shareholders may in writing direct.

Section 206 requires that no dividend shall be paid by a company in respect of any share therein, except—

(*a*) to the registered shareholder of share or to his order or to his bankers; or

(*b*) in case a share warrant has been issued, to the bearer of such warrant or to his bankers.

This provision is not deemed to require the bankers of a registered shareholder to make a separate application to the company for the payment of dividend.

Section 207 provides that where a dividend has been declared by a company but has not been paid, or the warrant in respect thereof has not been posted, within forty-two days from the date of the declaration, to any shareholder entitled to dividend, every director of the company; its managing agent or secretaries and treasurers; and where the managing agent or secretaries and treasurers are a firm or body corporate, every partner or director thereof as the case may be; shall, if he is knowingly a party to the default, be punishable with simple imprisonment upto seven days and fine.

However, no offence shall be deemed to have been committed under the above provision in the following cases, namely:—

(*a*) where the dividend could not be paid by reason of any law;

(*b*) where a shareholder has given directions to the company re-

garding the payment of the dividend and those directions cannot be complied with;

(*c*) where there is a dispute regarding the right to receive the dividend;

(*d*) where the dividend has been lawfully adjusted by the company against any sum due to it from the shareholder; or

(*e*) where, for any other reason, the failure to pay the dividend or to post the warrant within the period aforesaid was not due to any default on the part of the company.

Under Section 93, a company may, if so authorised by its Articles, pay dividends in proportion to the amount paid up on each share where a larger amount is paid up on some shares than on others.

Clause 89 of Table "A" provides that the Board may deduct from any dividend payable to any member, any sum presently payable by him to the company on account of calls or otherwise in relation to the shares of the company.

Clause 94 of Table "A" provides that no dividend shall bear interest against the company.

(B) Interim Dividends

Under Clause 86 of Table "A", Companies Act, 1956, the Board may from time to time pay to the members such interim dividends as appear to it to be justified by the profits of the company, and where this Table applies, or the operation of this clause is not excluded, the directors will have this power. Most companies having Articles of their own empower the directors to pay interim dividends.

The question as to whether a company is justified in paying an interim dividend, and, if so, to what extent, is a most important one, and the advice of the auditor is frequently asked for. In such circumstances, he should suggest that interim accounts be prepared for the purpose of ascertaining what profits have been made. Many companies have half-yearly accounts prepared for this reason. Assuming such accounts to have been prepared, and that a profit is shown after making all the necessary adjustments and proper provisions for depreciation, bad debts, etc., the question will arise as to what proportion of such profit can be applied

in payment of an interim dividend. Certain considerations must be taken into account before it is possible to arrive at a decision as to the rate of dividend to be paid. Where the dividend is in respect of preference shares, the dividends on which are expressed to be payable half-yearly, and there is ample margin of profit, the full half-yearly dividend may be paid; but in the case of ordinary shares it is advisable that the interim dividend should be declared at a lower rate than the estimated dividend for the whole year.

It must be remembered that an interim dividend is only a payment on account of the whole dividend for the year and, consequently, if an interim dividend is declared in respect of profits earned during a portion of the year, and during the remainder of the year a loss is made, resulting in a loss for the whole year, the interim dividend may have been paid out of capital.

The general conditions and prospects of the trade carried on by the company must, therefore, be taken into account in this connection. The financial aspect of the matter also requires consideration. If the liquid position of the company is not strong, and the whole of the funds in hand are required for carrying on the business, it is not advisable to reduce the resources by distributing an interim dividend, but this general principle may be subject to special considerations which will be referred to subsequently.

In the case of a company carrying on business of a regular and stable nature, where the rate of gross profit earned is subject to little, if any, variation, it may be possible to arrive at a sufficiently accurate estimate of the profits without taking stock or preparing completed accounts. The gross profit for the period can be estimated by reference to the turnover at the average percentage earned in previous years; and the actual expenses incurred by the company can be ascertained. After all the necessary allowances have been made for outstandings, provisions, etc., the net profit can be estimated with sufficient accuracy, although in such cases a greater margin for contingencies should be allowed in fixing the rate of dividend than when actual accounts have been prepared.

It is sometimes thought by persons unacquainted with the fundamental principles of accounts, that if there is a considerable cash balance, this fact is in itself sufficient to justify the payment

of an interim dividend, and that the preparation of a Receipts and Payments Account is an adequate substitute for an interim Profit and Loss Account. This idea is entirely fallacious, and, if acted upon, might easily result in the dividend being paid out of capital.

The Receipts and Payments Account might include receipts on account of capital or loans, the proceeds of which have not yet been expended, with the result that a large balance remains in hand; or, on the other hand, considerable capital payments might have been made with the result that the balance in hand might be less, rather than more than the actual profit earned.

No account is taken of fluctuation in the amounts of stock, debtors or creditors. Stock and debtors might be materially less than at the commencement of the period, and, consequently, the cash balance might be increased, or the creditors might be greater, with a similar result; in neither case might any profit have been earned. No account is taken of the provisions necessary for bad debts, depreciation, or other losses which may not have arisen through cash transactions. Consequently, it is quite conceivable that there might be a large cash balance, when, as a matter of fact, a loss has been sustained, or a small cash balance when a considerable profit has been earned; and, therefore, no reliance can be placed upon a Receipts and Payments Account for the purpose of determining whether or not an interim dividend should be paid.

Where a bonus was improperly declared on the faith of a surplus shown by a Receipts and Payments Account, without the preparation of a Profit and Loss Account and Balance Sheet, and without making due allowance for outstandings, the Court ordered a director who had participated in the bonus to refund the amount received by him (*Rance's Case,* 1870, L.R. 6 Ch. App. 104).

(c) Final Dividends

Clause 85 of Table "A" provides that the company in general meeting may declare dividends, but no dividend shall exceed the amount recommended by the Board.

The Articles usually give power to the directors to declare and pay final dividends on preference shares, but not on ordinary shares, a resolution of the members in general meeting being required to authorise the latter.

In no case should a final dividend be declared until the accounts of the year have been prepared and the actual divisible profits ascertained. The considerations which will guide the directors in recommending to the members the amount of the final dividend are similar to those discussed above; and it has already been pointed out that in most cases no dividends can be declared unless previously recommended by the directors, and that they usually have absolute discretion as to the amount they consider it advisable should be distributed, having regard to the actual profits earned by the company, and to their power to place to reserve any amount they may think necessary before recommending the payment of a dividend. In *Bond* v. *Barrow Haematite Steel Co.* (1902 1 Ch. 353), Farwell, J., said that the Court would be very reluctant to compel directors to divide more than they thought proper; and the Courts will not compel a division of profits up to the hilt, as they regard it as perfectly proper and lawful for a company to carry forward a portion of the year's profits to the credit of next year's Profit and Loss Account (*Burland* v. *Earle*, 1902 A.C. 93).

Clause 88 of the present Table "A" provides that—

(1) Subject to the rights of persons, if any, entitled to shares with special rights as to dividends, all dividends shall be declared and paid according to the amounts paid or credited as paid on the shares.

(2) The amount paid on a share in advance of calls should not be treated for this purpose as an amount paid on the share.

(3) All dividends shall be apportioned and paid proportionately to the amounts paid or credited as paid on the shares during any portion or portions of the period in respect of which the dividend is paid; but if any share is issued on terms providing that it shall rank for dividend as from a particular date such share shall rank for dividend accordingly.

(D) Preference Dividends

The rights of preference shareholders to dividends will be defined in the Articles, and the question as to whether such shareholders are entitled to simple or cumulative dividends in the absence of express provisions has been considered in Chapter VIII, § 2.

In respect of preference shares which have been issued and subscribed for before the 1st day of April, 1960, the Preference Shares (Regulation of Dividends) Act, 1960 makes provisions for specified increases of dividends on preference shares consequent upon the introduction of the new scheme of company taxation.

(E) ARREARS OF CUMULATIVE PREFERENCE DIVIDENDS

There must be shown as a foot-note to the Balance Sheet or in a statement annexed to the accounts the amount of any arrears of fixed cumulative dividends before deduction of income tax, and the period for which the dividends or, if there is more than one class, each class of them are in arrear. When the dividends are payable free of income tax, the free of tax amount of the arrears will be shown, and this fact stated (Schedule VI, Part I, Companies Act, 1956).

(F) DIVIDENDS PAID OUT OF CAPITAL

Dividends must only be paid out of profits and cannot be paid out of capital, and if the Memorandum or Articles of Association give power to the company to do so, such power is invalid (*Verner* v. *General & Commercial Investment Trust, Ltd.*, 1894 2 Ch. 239; *re Sharpe*, 1892 1 Ch. 154).

Where it is alleged that a dividend has been paid out of capital, the onus is on the plaintiff to prove that the dividend comes out of capital.

Directors who knowingly pay dividends out of capital are personally liable to make good the amount of such dividends to the company (*Oxford Benefit Building Society*, 1886 35 Ch. D. 502; *re London & General Bank*, 1895 2 Ch. 673; *re Kingston Cotton Mill Company*, (No. 2), 1896 2 Ch. 279); but where such payment was made on the faith of a *bona fide* valuation of a company's assets, which subsequently proved to be an over-estimate, the directors were not liable (*Stringer's Case*, 1869 4 Ch. 475; *Rance's Case*, 1870 6 Ch. 104); although if the Articles state that dividends are only payable out of realised profits, the directors may be responsible for a dividend paid out of estimated profits (*Oxford Benefit Building Society*, 1886 35 Ch. D. 502).

Directors are entitled to rely upon reports and valuations of trusted officers of a company, unless there is reasonable ground

for suspicion (*Re Kingston Cotton Mill Co.* [No. 2], 1896 2 Ch. 279; *Dovey* v. *Cory,* 1901 A.C. 477).

If dividends are received by members, knowing that they are paid out of capital, the directors may have a right of indemnity against such members to the extent to which they have respectively received dividends, although they have not such right of indemnity if they represent that the dividend is paid out of profits (*Moxham* v. *Grant,* 1900 1 Q.B. 88); but the directors will primarily be liable to the company (*Re Alexandra Palace Co.,* 1882 21 Ch. D. 149; *National Funds Assurance Co.,* 1878 10 Ch. D. 118). Where an interim dividend has been paid out of capital owing to a *bona fide* mistake, and the directors propose to recoup such dividend out of profits before distributing any further dividends, a member who has received such dividend cannot maintain an action against the directors (*Towers* v. *African Tug Co.,* 1904 1 Ch. 558); and when dividends improperly paid out of capital have been made good out of subsequent profits, liability ceases to attach to the directors (*Boaler* v. *The Watchmakers' Alliance, and others,* 1903, Acct. L.R. 23).

The liability of the auditor in connection with the payment of dividends out of capital is fully dealt with in Chapter XII.

(G) Vouching Dividends

The auditor must examine the terms of the resolution of the directors or shareholders by which the dividend has been declared and satisfy himself that the dividend rights attaching to each class of shares, as defined by the Articles, have been complied with. A representative number of the entries on the dividend list should be tested with the register of members, and a number of the calculations of gross and net dividends shown as payable to individual shareholders should also be checked. It must be seen that the total of the shareholdings shown by the list agrees with the total issued share capital of the class on which the dividend is payable, and that the totals of the columns for gross dividend, income tax and net dividend are in agreement with the dividend declared.

It is usual, in the case of public companies, for a separate banking account to be opened for each dividend declared, an amount equal to the total of the net dividend payable being transferred

thereto from the main account. The bank statement should be checked or tested with the dividend list and the balance, representing dividends so far unclaimed, identified and also verified by banker's certificate. The auditor should vouch a number of the entries on the dividend list with the returned dividend warrants, seeing that the cheques were made payable to the shareholders concerned or in accordance with mandates given by them to the company authorising payment to be made to bankers or others.

(H) UNCLAIMED DIVIDENDS

Dividends are sometimes unclaimed, and where this is so, the amount should be shown as a liability on the Balance Sheet. If a separate banking account is utilised for the payment of dividends, the unclaimed dividends will appear as a balance on this account as against the corresponding liability.

Dividends constitute a debt and under Article 120 of the First Schedule to the Indian Limitation Act, 1908, do not become statute barred for six years. However, under the Limitation Bill, 1962, the period of limitation of three years is proposed.

Power may be taken in the Articles to forfeit unclaimed dividends but this is unusual, since the recognised Stock Exchanges will not grant an official quotation of the shares where the company has this power.

(I) RESERVES FOR THE EQUALISATION OF DIVIDENDS

Where the profits of a company fluctuate considerably from year to year, it is sometimes found desirable to institute a reserve for the equalisation of dividends, profits being transferred to the credit of this account in good years, and withdrawn subsequently when the current year's profits are insufficient to pay the average rate of dividend desired.

If the circumstances of the company are such that the amounts so placed to the credit of the Equalisation Reserve are liable to become locked up in the general assets of the company, and are thus not readily available for the payment of cash dividends when required, it may be desirable that the amounts placed to the credit of the Equalisation Reserve Account should be represented by specific investments, which can be realised as occasion arises.

Equalisation reserves will be shown in the Balance Sheet as revenue reserves.

CHAPTER XII

THE LIABILITY OF AUDITORS

§ 1. The Liability of Auditors

An auditor's liability, in relation to accounts which he has audited, may be of two types:

(1) Contractual liability, and/or

(2) Statutory liability.

The nature of the liability, which may arise, may fall into two categories, viz.,

(i) Civil liability,

(ii) Criminal liability.

§ 2. Liability for Negligence

Every agent is presumed to bring reasonable skill and diligence to bear upon the work which he is employed to do, and an auditor, who may be said to be an agent to the extent of his duties as auditor, is no exception to this rule. If, therefore, an auditor is guilty of negligence in the execution of his duty, he may be held liable to make good any damage resulting from that negligence.

This liability springs from the general principle of law that where a person is under a legal duty to take care, whether imposed by specific contract or otherwise, the failure to exercise a *reasonable standard* of care will make that person responsible for any resultant damage or loss *to those to whom the duty is owed.* This liability does not, however, extend to third parties who may have been prejudiced by the negligence, as there is no contractual relationship between the auditor and such parties.

What conduct satisfies the standard of care required will, in any particular case, depend entirely upon the circumstances. The general average of skill and diligence attained by auditors has reached a high standard, and the question as to whether an auditor is or is not guilty of negligence in any particular case, is largely determined by a comparison with the standard to which the average members of the profession conform.

§ 3. Liability under Statute

(A) CIVIL

Under the Companies Act, 1956, by virtue of Section 2(30), the term "Officer" includes an auditor for the purposes of Sections 477, 478, 539, 543, 545, 621, 625 and 633.

(1) *Companies Act,* 1956.

Under Section 543, if in the course of the winding up of a company it appears that the auditor has been guilty of any misfeasance or breach of trust in relation to the company, he may be held liable as an officer of the company. The Court, on the application of the Official Liquidator, the liquidator or any creditor or contributory, may examine into his conduct, and compel him to contribute such sum to the assets of the company by way of compensation in respect of the misfeasance or breach of trust as the Court thinks just. Liability under this section can only arise in the case of the winding up of a company.

It is laid down by Section 633, however, that where in any proceedings for negligence, default, breach of duty, misfeasance or breach of trust against an officer (including an auditor), it appears to the Court hearing the case—

(*a*) that he is or may be liable; and

(*b*) that he has acted honestly and reasonably; and

(*c*) that, having regard to all the circumstances of the case, including those connected with his appointment, he ought fairly to be excused for the negligence, etc.,

the Court may relieve him wholly or partly on such terms as it may think fit.

Where any such auditor has reason to apprehend that any proceeding will, or might be brought against him, in respect of any negligence, default, breach of duty, misfeasance or breach of trust, he may apply to the High Court for relief without waiting for proceedings to be taken against him. The Court, on such an application, has the same power to relieve him as it would have had if it had been the Court before which proceedings against him for negligence, etc., had been brought.

Section 233 provides as under:

"If any auditor's report is made, or any document of the company is

signed or authenticated, otherwise than in conformity with the requirements of sections 227 and 229, the auditor concerned, and the person, if any, other than the auditor who signs the report or signs or authenticates the document, shall, if the default is wilful, be punishable with fine which may extend to one thousand rupees."

Section 57, provides that a prospectus shall not include a statement purporting to be made by an expert (which expression includes an accountant), unless he is not or has not been engaged or interested in the formation or promotion or in the management, of the company. Under Section 59, every person who is knowingly a party to the issue of a prospectus in contravention of Section 57, is punishable with a fine which may extend to Rs. 5,000.

Under Section 62, where a prospectus is issued inviting persons to subscribe for shares or debentures of a company, an accountant is liable, in respect of an untrue statement, purporting to be made by him as an expert, to pay compensation to every person who subscribes for any shares or debentures on the faith of the prospectus, for any loss or damage he may have sustained by reason of any untrue statement included therein. However, the accountant will not be so liable if he proves that—

(1) the prospectus was issued without his knowledge or consent and that on becoming aware of its issue, he forthwith gave reasonable public notice to that effect; or
(2) he withdrew his consent, in writing before delivery of the prospectus for registration; or
(3) after delivery for registration and before allotment, he, on becoming aware of the untrue statement, withdrew his consent in writing and gave reasonable public notice of the withdrawal and of the reasons therefor; or
(4) he was competent to make the statement and that he had reasonable grounds to believe, and did up to the time of allotment, believe, that the statement was true.

Section 62(4) provides for indemnity where the accountant has either not given consent under Section 58 or has withdrawn it before the issue of the prospectus.

(B) CRIMINAL

(1) *Companies Act*, 1956.

If an auditor in any return, report, certificate, Balance Sheet,

prospectus, statement or other document required by or for the purposes of any of the provisions of the Act, makes a statement false in any material particular, knowing it to be false; or omits any material fact knowing it to be material, he may, save as otherwise expressly provided in the Act, be punishable with imprisonment for a term which may extend to two years and may also be liable to a fine (Section 628).

Conviction under this section will not operate to relieve the auditor from liability for misfeasance, etc., under Section 543. Section 539 provides that where an auditor of a company which is being wound up, with intent to defraud or deceive any person—

(*a*) destroys, mutilates, alters, falsifies or secretes, or is privy to the destruction, mutilation, alteration, falsification or secreting of, any books, papers or securities; or

(*b*) makes, or is privy to the making of, any false or fraudulent entry in any register, book of account or document belonging to the company,

he shall be punishable with imprisonment for a term which may extend to seven years, and shall also be liable to a fine.

Section 63 provides that where a prospectus issued after 1st April 1956 includes any untrue statement, every person, who authorises the issue of the prospectus, shall be punishable with imprisonment up to two years or a fine up to Rs. 5,000 or with both; unless he proves that he had reasonable grounds to believe, and did, up to the time of the issue of the prospectus believe, that the statement was true. However an accountant shall not be deemed to have authorised the issue of a prospectus merely by reason of his having given the necessary consent under Sections 58 or 60(3).

Section 68 deals with penalty for fraudulently inducing persons to invest moneys.

In view of these provisions, the auditor should be extremely cautious while certifying, any statements for inclusion in a prospectus or any statements on the basis of which any person may be induced to invest moneys.

(2) *The Indian Penal Code.*

Section 197, the Indian Penal Code, provides that whoever issues or signs certificate required by law to be given or signed,

or relating to any fact of which such certificate is by law admissible in evidence, knowing or believing that such certificate is false in any material point, shall be punishable in the same manner as if he gave false evidence.

§ 4. Indemnity

Under Section 201, except as provided therein, any provision, whether contained in the Articles, or in an agreement or in any other instrument for exempting the auditor from or indemnifying him against, any liability which, by virtue of any rule of law, would otherwise attach to him in respect of any:

(1) negligence;
(2) default;
(3) misfeasance;
(4) breach of duty; or
(5) breach of trust;

of which he may be guilty in respect of the company, is void.

However, a company may indemnify an auditor against any liability incurred by him in defending any proceedings, whether civil or criminal:

(i) in which judgment is given in his favour; or
(ii) in which he is acquitted or discharged; or
(iii) in connection with any application under Section 633 in which relief is granted to him by the Court.

Under Article 99, Table "A", every officer or agent of the company may be indemnified out of the assets of the company against any liability incurred by him in respect of proceedings for which an exception is made as aforesaid.

§ 5. Legal Decisions

(A) LEEDS ESTATE BUILDING AND INVESTMENT CO. V. SHEPHERD (1887 36 Ch. D. 787).

Held—THAT AN AUDITOR WHO FAILS TO SATISFY HIMSELF THAT TRANSACTIONS ARE *ULTRA VIRES* THE DIRECTORS IS NEGLIGENT.

This company was formed for the purpose of dealing in loans and lending money on mortgage; the remuneration of the directors was payable in proportion to the dividend paid, no dividend

being payable except out of profits. No profit was made by the company during the whole period in which it carried on business, except in one year. The action was brought by the company against the directors, the manager, and the auditors, to make them liable in respect of certain sums paid out of capital for dividend, and the fees and bonuses of the directors and manager respectively. The Balance Sheets were false and misleading, and contained fictitious items, having been prepared with a view to the declaration of dividends.

The accounts were examined by the auditor, but he was not furnished with a copy of the Articles, and he did not comply with their provisions. The directors were not aware that dividends had been paid out of capital, or that the Balance Sheets were inaccurate.

In the course of his judgment, Stirling, J., said:

"It is the duty of the auditor not to confine himself merely to the task of ascertaining the arithmetical accuracy of the balance sheet, but to see that it is a true and accurate representation of the company's affairs. It was no excuse that the auditor had not seen the articles when he knew of their existence. The Statute of Limitations had been pleaded on his behalf, and the plea had not been resisted so that his liability would be limited to the dividends paid within six years of the commencement of the action."

(B) IN RE LONDON AND GENERAL BANK (No. 2). (1895 2 Ch. 673).

Held—THAT AN AUDITOR, WHO DOES NOT REPORT TO THE SHAREHOLDERS THE FACTS OF THE CASE WHEN THE BALANCE SHEET IS NOT PROPERLY DRAWN UP, IS GUILTY OF MISFEASANCE.

This was an appeal by Mr. Theobald, one of the auditors of the London & General Bank, which was being wound up, against an order made by Vaughan Williams, J., under Section 10 of the Companies (Winding-up) Act, 1890 (corresponding to Section 543, Companies Act, 1956). By this order Mr. Theobald and the directors of the bank were declared jointly and severally liable to pay to the Official Receiver of the company two sums of £5,946 12s. and £8,486 11s., being respectively the amounts of dividends declared and paid by the bank for the years 1890 and 1891, with interest on those sums. The grounds on which

this order was made on Mr. Theobald were that these dividends were paid out of capital, and that such payment was made pursuant to resolutions of the shareholders, based upon the recommendations of the directors of the bank, and upon Balance Sheets prepared and certified by Mr. Theobald, which did not fully represent the financial position of the company.

The failure of the company was principally due to the fact that large sums had been advanced to customers on loan and current account, in respect of which the security lodged was entirely insufficient, and the dividends in question were paid out of sums taken to the credit of profit and loss in respect of interest on such advances, which interest was never, as a fact, paid. Had proper provision been made for bad debts in respect of sums advanced, and interest accrued thereon, the accounts of the company would not have shown a profit, but a loss.

The Court held that the auditor was liable to refund, by way of damages, the amount of the second dividend, on the ground that he was aware of the critical position of affairs, and acted negligently in not reporting the facts to the shareholders, although he reported them to the directors. As regards the first dividends, the Court did not hold the auditor liable, as it was of opinion that the evidence was not sufficiently strong to establish a case of misfeasance against him, although it thought he was guilty of an error of judgment.

In the course of his judgment, Lindley, L.J., said (Acct. L.R. 1895, 173):

"It is no part of an auditor's duty to give advice either to directors or shareholders as to what they ought to do. An auditor has nothing to do with the prudence or imprudence of making loans with or without security. It is nothing to him whether the business of a company is being conducted prudently or imprudently, profitably or unprofitably; it is nothing to him whether dividends are properly or improperly declared, provided he discharges his own duty to the shareholders. His business is to ascertain and state the true financial position of the company at the time of the audit and his duty is confined to that. But then comes the question: How is he to ascertain such position? The answer is: By examing the books of the company. But he does not discharge his duty by doing this without enquiry, and without taking any trouble to see that the books of the company themselves show the company's true position. He must take reasonable care to ascertain that they do. Unless he does this, his duty will be worse than a farce. Assuming the books to be so kept as to show

the true position of the company, the auditor has to frame a balance-sheet showing that position according to the books, and to certify that the balance-sheet presented is correct in that sense. But his first duty is to examine the books, not merely for the purpose of ascertaining what they do show, but also for the purpose of satisfying himself that they show the true financial position of the company. An auditor, however, is not bound to do more than exercise reasonable care and skill in making enquiries and investigations. He is not an insurer; he does not guarantee that the books do correctly show the true position of the company's affairs; he does not guarantee that his balance-sheet is accurate according to the books of the company. If he did, he would be responsible for an error on his part, even if he were himself deceived, without any want of reasonable care on his part—say by the fraudulent concealment of a book from him. His obligation is not so onerous as this.

"Such I take to be the duty of the auditor; he must be honest—that is, he must not certify what he does not believe to be true, and he must take reasonable care and skill before he believes that what he certifies is true.

"What is reasonable care in any particular case must depend upon the circumstances of that case. Where there is nothing to excite suspicion, very little enquiry will be resonable and quite sufficient; and in practice, I believe, business men select a few cases haphazard, see that they are right and assume that others like them are correct also. When suspicion is aroused, more care is obviously necessary; but still, an auditor is not bound to exercise more than reasonable care and skill, even in a case of suspicion; and he is perfectly justified in acting on the opinion of an expert where special knowledge is required....

"A person whose duty it is to convey information to others does not discharge that duty by simply giving them so much information as is calculated to induce them, or some of them, to ask for more. Information and means of information are by no means equivalent terms.... An auditor who gives shareholders means of information, instead of information, in respect of a company's financial position, does so at his peril, and runs the very serious risk of being held, judicially, to have failed to discharge his duty.

"In this case I have no hesitation in saying that Mr. Theobald did fail to discharge his duty to the shareholders, in certifying and laying before them the balance-sheet of February, 1892, without any reference to the report which he laid before the directors, and with no other warning than is conveyed by the words, 'The value of the assets as shown on the balance-sheet is dependent upon realisation....' It is a mere truism to say that the value of loans and securities depends upon their realisation. We are told that a statement to that effect is so unusual that the mere presence of those words is enough to excite suspicion. But, as already stated, the duty of an auditor is to convey information, not to arouse enquiry, and although an auditor might infer from an unusual statement that something was seriously wrong, it by no means follows that ordinary people would have their suspicions aroused by a similar statement if, as in this

case, its language expresses no more than any ordinary person would infer without it."

In the course of his judgment, Rigby, L.J., said:

"The words 'as shown by the books of the company' seem to me to be introduced to relieve the auditors from any responsibility as to affairs of the company kept out of the books and concealed from them, but not to confine it to a mere statement of the correspondence of the balance-sheet with the entries in the books. Now, a full and fair balance-sheet must be such a balance-sheet as to convey a truthful statement as to the company's position. It must not conceal any known cause of weakness in the financial position, or suggest anything which cannot be supported as fairly correct in a business point of view."

In the case of *Pendleburys Ltd.* v. *Ellis, Green & Co.* (Acct., 28th March 1936), it was held that where the directors of a *private* limited company are the sole shareholders, a report to the directors made by the auditors will discharge the liability of the latter to give similar information in their report to the members. In the course of his judgment, Mr. Justice Swift stated that, when having regard for the duties which an auditor owes to the members, some distinction must be drawn between a company with a large number of shareholders and one with two or three shareholders who happen also to be the directors.

(c) IN RE THE KINGSTON COTTON MILL CO., LIMITED (No. 2). (1896 2 Ch. 279).

Held—THAT IT IS NOT THE DUTY OF THE AUDITOR TO TAKE STOCK; AND THAT HE IS NOT GUILTY OF NEGLIGENCE IF HE ACCEPTS THE CERTIFICATE OF A RESPONSIBLE OFFICIAL IN THE ABSENCE OF SUSPICIOUS CIRCUMSTANCES.

This was an appeal by the auditors of the Kingston Cotton Mill Company, Ltd. (then in liquidation), against an order made by Vaughan Williams, J., under Section 10, Companies (Winding-up) Act, 1890 (corresponding to Section 543, Companies Act, 1956) under which they were made liable to contribute to the assets of the company a sum equal to the amount improperly applied in payment of dividends on the faith of certain Balance

Sheets examined by them. The profits of the company were increased fictitiously by deliberate manipulation of the quantities and values of the stock-in-trade, and the question was whether the auditors were guilty of negligence in accepting the certificate of the manager as to the correctness of the stock-in-trade without checking the stock in detail. The facts of the case appear sufficiently from the following extract from the judgment of Lindley, L.J. (Acct. L.R. 1896, 77).

"For several years frauds were committed by the manager, who in order to bolster up the company and make it appear flourishing when it was the reverse, deliberately exaggerated both the quantities and values of the cotton and yarn in the company's mills.... The auditors took the entry of the stock-in-trade at the beginning of the year from the last preceding balance-sheet, and they took the values of the stock-in-trade at the end of the year from the stock journal. The book contained a series of accounts under various heads purporting to show the quantities and values of the company's stock-in-trade at the end of each year, and a summary of all the accounts showing the total value of such stock-in-trade. The summary was signed by the manager, and the value as shown by it was adopted by the auditors and was inserted as an asset in the balance-sheet, but 'as per manager's certificate.' The summary always corresponded with the accounts summarised, and the auditors ascertained that this was the case. But they did not examine further into the accuracy of the accounts summarised. The auditors did not profess to guarantee the correctness of this item. They assumed no responsibility for it. They took the item from the manager, and the entry in the balance-sheet showed that they did so. I confess I cannot see that their omission to check his returns was a breach of their duty to the company. It is no part of the auditor's duty to take stock. No one contends that it is. He must rely on other people for details of the stock-in-trade in hand. In the case of a cotton mill he must rely on some skilled person for the materials necessary to enable him to enter the stock-in-trade at its proper value in the balance-sheet."

Lopes, L.J., in the course of his judgment made the following remarks:

"It is the duty of an auditor to bring to bear on the work he has to perform that skill, care and caution which a reasonably competent, careful and cautious auditor would use. What is reasonable skill, care and caution must depend on the particular circumstances of each case. An auditor is not bound to be a detective, or, as was said, to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watch dog, but not a bloodhound. He is justified in believing tried servants of the company in whom confidence is placed

by the company. He is entitled to assume that they are honest, and to rely upon their representations, provided he takes reasonable care. If there is anything calculated to excite suspicion he should probe it to the bottom, but in the absence of anything of that kind, he is only bound to be reasonably cautious and careful.... The duties of auditors must not be rendered too onerous. Their work is responsible and laborious, and the remuneration moderate. I should be sorry to see the liability of auditors extended any further than in *In re The London & General Bank* (*supra*), indeed, I only assented to that decision on account of the inconsistency of the statement made to the directors with the balance-sheet certified by the auditors and presented to the shareholders. This satisfied my mind that the auditors deliberately concealed that from the shareholders which they had communicated to the directors. It would be difficult to say this was not a breach of duty. Auditors must not be made liable for not tracking out ingenious and carefully laid schemes of fraud, when there is nothing to arouse their suspicion and when those frauds are perpetrated by tried servants of the company and are undetected for years by the directors. So to hold would make the position of an auditor intolerable."

(D) THE IRISH WOOLLEN CO., LIMITED, v. TYSON AND OTHERS (1900 Acct. L.R. 13).

Held—THAT AN AUDITOR IS LIABLE FOR ANY DAMAGE SUSTAINED BY A COMPANY BY REASON OF FALSIFICATIONS WHICH MIGHT HAVE BEEN DISCOVERED BY THE EXERCISE OF REASONABLE CARE AND SKILL IN THE PERFORMANCE OF THE AUDIT.

This case was heard before the Irish Court of Appeal, and was an appeal by Mr. Edward Kevans, the auditor, against the judgment of the lower Court, holding him responsible for the non-detection of the fraud. The appeal was dismissed.

The frauds were principally occasioned by the suppression of invoices outstanding at the date of the Balance Sheet, thus reducing the amount of purchases and the amount of creditors. The goods, however, were taken into stock and a fictitious profit was therefore shown to that extent. This amounted ultimately to £4,095.

The Court gave considerable weight to the fact that a special arrangement was come to between the company and the auditor, for a monthly audit to be conducted, which should lead up to the half-yearly audit. This monthly audit consisted merely in check-

ing the current details and did not involve the preparation of monthly Profit and Loss Accounts or Balance Sheets.

In the course of his judgment, Holmes, L.J., said:

"Mr. Kevans seems to have done little of the actual work himself, and the evidence varies as to the nature of the supervision which he gave to it; the investigation of the books he deputed to his assistants.... and it must be on the faith of their representations that he certified the balance-sheets. I presume this course is not unusual, and that an accountant with a large business is not supposed to do everything himself. The auditor is bound to give reasonable care and skill, but this can also be exercised by his deputy.... There is no doubt that both the suppression and carrying over of invoices would have been detected if the auditor had called for the creditors' statements of account upon which payment was ordered, and compared them with the ledger. I should have thought this was part of the auditor's duty for many reasons; but . . . apart altogether from the statements of account and the monthly check, I do not understand how the carrying over of the invoices could have escaped detection by the accountant, who should have used due care and skill, and who was not a mere machine. The invoices carried over were ultimately posted to the ledger. If they were posted to their true dates, it would be at once apparent that they were not entered in at the proper time. If they were posted under false dates, why was this not detected when the ledger accounts were checked with the invoices? And when no invoices came into the books, it is admitted that this ought to have excited suspicion. For these reasons I am of opinion that if due care and skill had been exercised, the carrying over and the suppression of invoices would have been discovered, and the auditor is liable for any damage the company has sustained from the under-statement of liabilities in the balance-sheet due to this cause since 4th January 1892. I consider that not only are Mr. Kevans and his assistants not free from blame for this, but also for the mechanical way the audit was carried out."

(E) THE LONDON OIL STORAGE CO. LIMITED, V. SEEAR, HASLUCK & CO. (1904, Acct. L.R 30, 93).

Held—THAT THE AUDITOR IS LIABLE FOR ANY DAMAGE SUSTAINED BY A COMPANY BY REASON OF HIS OMISSION TO VERIFY THE EXISTENCE OF ASSETS STATED IN THE BALANCE SHEET.

This was an action brought by the company for damages for alleged neglect by the auditor in omitting to verify the existence of a sum of £796, shown in the Balance Sheet as petty cash in hand. As a fact, the balance in hand was only £30, and the

difference had been misappropriated by the secretary, who kept the Petty Cash Book.

The auditor's clerk did not count the balance of cash in hand, but merely referred to the Petty Cash Book, to see that the amount shown in that book agreed with the amount shown in the Balance Sheet.

This case was heard before Alverstone, C.J., and a special jury, with the result that the jury found that the auditor had committed a breach of duty, and assessed the damages at five guineas. The jury considered that the directors had been guilty of gross negligence in allowing such a large balance of cash to remain in the hands of the petty cashier, and it was owing to this fact that the damages given against the auditor were only nominal.

In the course of his summing-up, Alverstone, C.J., said:

"The auditor most undoubtedly does undertake very considerable responsibilities, and is liable for the proper discharge of his duties, and if by the neglect of his duties, or by want of reasonable care, he neglects his duty, and damage is caused to the company as such, he is responsible for that damage.... The plaintiffs must satisfy you that the damage has been occasioned, to whatever extent you think it was occasioned, by the breach of duty on the part of the auditor.... The conduct of the directors is no answer to any breach of duty by the defendant, but it is a circumstance you must take into consideration, because if you are of opinion that the loss was occasioned by the man stealing the money in consequence of there being a want of proper control over him, then the fact of there being a breach of duty by the auditor is what we lawyers call a *causa causans*, which contributed to, but would not be the cause of, the loss.... Was he guilty of breach of duty, and, if so, what loss was occasioned to this company by that breach of duty? You must not put upon him the loss by reason of theft occurring afterwards or before, but you must put upon him such damages as you consider in your opinion were really caused by his not having fulfilled his duty as auditor of the company."

(F) ARTHUR E. GREEN & COMPANY, V. THE CENTRAL ADVANCE & DISCOUNT CORPORATION LTD. (1920, Acct. L.R. LXIII, p. 1).

Held—THAT AN AUDITOR IS GUILTY OF NEGLIGENCE WHEN HE ACCEPTS A SCHEDULE OF BAD DEBTS FURNISHED BY A RESPONSIBLE OFFICIAL, ALTHOUGH IT IS APPARENT THAT OTHER DEBTS NOT INCLUDED IN THE SCHEDULE ARE ALSO IRRECOVERABLE.

This case is of importance in that it shows that an auditor is not entitled to rely upon the statement of an official, however apparently trustworthy, where, but for the confidence reposed in him, it should be evident that his statement is inaccurate.

The defendant company were moneylenders against whom the auditors claimed the fees due to them. The defendants counterclaimed for negligence and were awarded damages.

The plaintiffs had audited the company's books for many years, and over a considerable period worthless debts to the value of nearly £19,000 had accumulated. Some of these debts had been outstanding for a number of years and a great proportion were actually statute-barred, and therefore should have been regarded for all practical purposes as irrecoverable.

The auditor accepted the figures supplied by the managing director and the board as to the amounts to be written off for bad and doubtful debts each year. The managing director had explained his reason for allowing old debts to remain on the books by saying that in moneylending business it did not matter how old the debts were, because people would come back and pay in order to be able to obtain further advances. Such an explanation, in the opinion of Shearman, J., was not a satisfactory one. On no occasion did the auditor refer to the state of the book debts in his report to the members.

His Lordship said that if there were circumstances which seemed to call for enquiry, the auditor must make the proper enquiry, and if he did not take the proper steps to have the matter sifted, he did not fulfil the duty the owed to the company as one of its officers.

In the case of *Scarborough Harbour Commissioners* v. *Robinson, Coulson, Kirby & Co.* (1934, Acct. L.R. 65), the Court of Appeal reversed the decision of the lower Court which had found the auditors guilty of negligence in failing to report to the Harbour Commissioners that a debt due to them appeared to be bad. It was shown that the auditors had reason to believe that the state of the debt in question was known to the Commissioners and that their policy was not to press immediately for payment. The Master of the Rolls in the course of his judgment laid emphasis on the fact that all the circumstances of the case must be considered, and said "it is difficult to reconstruct the circumstances, but, having

regard to all the facts of the case, it appears to me that the charge has not been made out."

(G) IN RE THE CITY EQUITABLE FIRE INSURANCE CO., LTD. (1924, Acct. L.R. 53 and 81).

This was an action brought by the Official Receiver as liquidator of the company under Section 215, Companies (Consolidation) Act, 1908 (corresponding to Section 543, Companies Act, 1956) against the directors and auditors for damages arising out of misfeasance. The case was heard before Mr. Justice Romer, who dismissed the action both against the directors and the auditors. The Official Receiver did not proceed with any appeal so far as the directors were concerned, but took the case against the auditors to the Court of Appeal, where the judgment of the first Court was unanimously confirmed and the auditors were held not to be liable.

The City Equitable Fire Insurance Company, Ltd., carried on re-insurance business. The chairman was also the senior partner in the firm of Ellis & Company, the company's stockbrokers, who at all material times were very heavily indebted to the company.

The charges against the auditors were ultimately confined to the contention that they were guilty of negligence in respect of the audit by them of the Balance Sheets of the company for the years ended 28th February 1919, 1920 and 1921 respectively, under the following three heads:

(1) Their misdescriptions in the Balance Sheets of the debts of Ellis & Co., and Mansell (the company's general manager) by including them under "Loans at call or short notice," or "Loans," or in the case of part of Ellis & Co.'s debt, under the heading of "Cash at Bank and in hand," and their consequent failure to disclose to the shareholders the existence of those debts.

(2) Their failure to detect the fact that much larger sums were in the hands of Ellis & Co. at the date of each of the Balance Sheets than were so included.

(3) Their failure to detect and report to the shareholders the fact that a number of the company's securities, which were in the

custody of Ellis & Co, were being pledged by that firm to its customers.

In the course of his judgment Mr. Justice Romer referred at some length to the duties of auditors as laid down by the judgments in *re London & General Bank* and *Leeds Estate Building and Investment Co.* v. *Shepherd,* referred to above, and stated that generally speaking the auditors in this case had displayed great care, skill, and industry in the discharge of their duties. He added, however, that if, even in any one instance, the auditors had fallen short of their strict duty they could not be excused merely because in general they had displayed the highest degree of care and skill.

With regard to the first charge, the judge held that the sums in the hands of Ellis & Co. ought not to have been described as "Cash at Bank and in Hand," but that no damages flowed from this misdescription, as he considered it would have made no difference to anyone, in the circumstances of the case, had the item been included under the heading of "Loans" or of "Sundry Debtors."

In dealing with the question of loans, he pointed out that if directors choose to lend monies to their brokers or their general manager, there is no reason why they should not do so, nor did he see any reason why the auditors should call the attention of the shareholders specifically to the fact of their having done so, although they must take care that they did not bring into the Balance Sheets at face value a debt that is not a good one. On this point he considered that on the evidence before them there were no grounds upon which the auditors were entitled to assume that at the time of the audit these debts were not good.

The second charge related to the fact that in consequence of the method of "window dressing" employed, much larger sums were in the hands of Ellis & Co. at the date of each Balance Sheet than appeared to be the case according to the books. This operation was effected by the nominal purchase of Treasury Bonds by Ellis & Co. shortly before, and a nominal resale immediately after, the close of each financial year of the company. In fact, these securities were never in the hands of Ellis & Co., but were retained by the sellers as security for a loan against them to Ellis & Co. Simi-

larly, in 1921, there was an alleged purchase and resale by Ellis & Co., of National War Bonds, both purchase and resale taking place a few days after the date of the company's Balance Sheet, although Ellis & Co. sent a bought note to the company recording the purchase as having taken place on the 25th of February. Ellis & Co. certified that they held these securities at the date of the Balance Sheet, and this certificate was accepted by the company's auditors.

The transactions were recorded in the company's books, and on examination in the light of after events it was apparent that the operations were of a "window dressing" character, but the judge held that the auditors had not been guilty of negligence in not detecting this from the books, having regard to the state of their knowledge at the date of each audit.

The third charge related to the failure of the auditors to detect and report to the shareholders the fact that a number of the company's securities in the custody of Ellis & Co. were pledged by that firm. The auditors relied upon the certificates of Ellis & Co. that these securities were held by them, and the question as to whether they were justified in accepting these certificates instead of inspecting the securities personally was dealt with at some length, and is of considerable importance.

In the course of his judgment Mr. Justice Romer said:

"That it is the duty of a company's auditor in general to satisfy himself that the securities of the company in fact exist and are in safe custody cannot, I think, be gainsaid. If authority for the proposition be required, it may be found in the passage from Lord Justice Lindley's judgment in the *London & General Bank* case, which has already been referred to. The auditor in that case, amongst other things, 'saw that the bills and securities entered in the books were held by the bank,' and this the Lord Justice plainly treated as being part of an auditor's 'legal standard of duty,' though he did not of course mean that in all cases the bills and securities should be lodged with the bank. He meant 'with the bank or in other proper custody.' Nor is it at all clear whether the Lord Justice meant that in all cases the securities should be personally inspected by the auditor. For an auditor may 'see' that the bank holds the securities in the sense that he satisfies himself of the fact. In the case of a responsible and reputable bank this, according to the evidence of Mr. Van de Linde, would seem to be the custom of auditors. But I think that it is a pity that there should be any such custom. It would be an invidious task for an auditor

to decide as to any particular bank whether its certificate should be accepted in lieu of personal inspection. The custom, too, at once raises the question, much debated in the course of the evidence before me, whether the courtesy of accepting a certificate should be extended to an insurance company or a safe deposit company. Indeed, if once it be admitted that, in lieu of inspecting the securities personally, the auditor may rely upon the certificate of the person in whose custody the securities have properly been placed, the auditor would be justified in accepting the certificate of any official of the company who happened to be in charge of the safe in which the securities are placed, supposing such official to be a reputable and responsible person. At some time or other it will, I think, have to be considered seriously whether it is not the duty of an auditor to make a personal inspection, in all cases where it is practicable for him to do so, whatever may be the standing and character of the person or company in whose possession the securities happen to be. I do not, however, propose to investigate this question further upon the present occasion. *For an auditor is not in my judgment ever justified in omitting to make personal inspection of securities that are in the custody of a person or company with whom it is not proper that they should be left.* Whenever such personal inspection is practicable, and whenever an auditor discovers that securities of the company are not in proper custody, it is his duty to require that the matter be put right at once, or, if his requirement be not complied with, to report the fact to the shareholders, and this whether he can or cannot make a personal inspection. The securities, retained in the hands of Ellis & Co. for periods long beyond the few hours in which securities must necessarily be from time to time in the possession of the company's stockbrokers, were not in proper custody. That Ellis & Co. were at all material times regarded, and reasonably regarded, by Mr. Lepine as a firm of the highest integrity and financial standing is not to the point. A company's brokers are not the proper people to have the custody of its securities, however respectable and responsible those brokers may be. There are of course occasions when, for short periods, securities must of necessity be left with the brokers, but the moment the necessity ceases the securities should be lodged in the company's strong room or with its bank, or placed in other proper and usual safe-keeping. In my judgment, not only did Mr. Lepine commit a breach of his duty in accepting, as he did from time to time, the certificate of Ellis & Co. that they held large blocks of the company's securities, but he also committed a breach of his duty in not either insisting upon those securities being put in proper custody or in reporting the matter to the shareholders. This was negligence, and but for Article 150, it would be my duty so to declare and to order Messrs. Langton & Lepine to make compensation for all the damages that such negligence caused to the company, directing an inquiry to ascertain what those damages were. For it is settled by authorities that are binding upon me that an auditor is an officer of the company within the meaning of sect. 215 of the Companies (Consolidation) Act, 1908, though Mr. Stuart Bevan, while

admitting that it was not open to him to argue the contrary in this court, reserved to his clients the right to contest the point in a superior one. But Article 150 in express terms includes the auditors of the company in the protection that it gives, and it must be taken to be one of the terms upon which the auditors were employed and gave their services. They are therefore protected, unless the negligence of Mr. Lepine in the matter was wilful. This it certainly was not, unless I am mistaken as to the true meaning of the phrase 'wilful negligence.' I have heard Mr. Lepine's evidence in the witness box, and I have inspected many of the numerous documents prepared by him for the purposes of the audits that he conducted. I am convinced that throughout the audits that he conducted he honestly and carefully discharged what he conceived to be the whole of his duty to the company. If in certain matters he fell short of his real duty, it was because in all good faith, he held a mistaken belief as to what that duty was. As against him and his partner, the application of the Official Receiver must accordingly be dismissed."

By the company's Articles the directors, auditors, secretary and other officers were to be indemnified against any liability attaching to them, unless the liability arose through their own wilful neglect or default. Such indemnification clauses are now void under Section 201, Companies Act, 1956, as discussed in § 4 of this Chapter.

The remarks of the Master of the Rolls on the question of the custody of securities are of great interest and are therefore quoted verbatim below.

The Master of the Rolls said:

"Now I come to the last point, part of which is contained in the third charge, and that is the failure to detect the fact that much larger sums were in the hands of Ellis & Co. at the date of the balance-sheet, and the failure to detect and report that the securities were in the hands of Ellis & Co. Now upon that matter I want to say a word or two about the evidence. In fact Mr. Lepine inquired from the bank and got a certificate from the bank that a certain number of securities were there, and then he turned to Ellis & Co., and he got from Ellis & Co. under the signature of Ellis & Co. a certificate attached to the document, apparently not by Mr. Bevan but by one of the partners, a certificate that a number of securities were in the hands of the stock-brokers. It is said it was quite wrong to accept the certificate of the brokers, and we are asked to accept the evidence of Mr. Cash and Mr. Van de Linde as meaning this, that you may accept the certificate of a bank apparently in all cases, but you may never accept the certificate of stockbrokers. I cannot agree that the evidence is so to be read, or is intended by the witnesses to be so understood.

What I think the witness meant to express was this: Banks in ordinary course do hold certificates of securities for their customers; it is part of their business, and therefore certificates in the hands of bankers are in their proper custody, and if then a bank is a reputable bank, a bank which holds a high position, you may legitimately accept the certificate of that bank because it is a business institution in whose custody you would expect both to find and to put securities, and also it is respectable, but the fact that it calls itself a bank does not seem to me to conclude the matter either one way or the other. On the other hand, it may be said that it is the duty of an auditor not to take a certificate as to possession of securities unless from a person who is not only respectable—I should prefer to use the word 'trustworthy'—and also of that class of persons who in the ordinary course of their business do keep securities for their customers, and it may be said that a broker does not in the ordinary course of business keep securities for his customers, and therefore he is ruled out because the auditor ought not to accept from a person of that class, whether he be respectable or not, a certificate that he has got securities in his hands. Now, accepting the rule as stated, that it is right to find the securities in the hands of the bank whose business it is to hold securities, and applying the proviso that that bank must be one that is trustworthy, it seems to me that that rule may be a right rule to follow, and I think it is *prima facie*, but it is going too far to say that under no circumstances may you be satisfied with securities in the hands of a stockbroker, because it seems to me in the ordinary course of business you must from time to time, and you legitimately may, place in the hands of stockbrokers securities for the purpose of their dealing with them in the course of their business. With a large institution like the City Equitable Company, with a very considerable amount of investments to make and investments to sell, it may well be that for the purpose of the convenience of all parties it may have been a useful method of business even if it had been examined with the most exiguous care, for the directors to decide that they would in the interest of their business leave securities of a considerable amount in the hands of their stockbrokers, who, I suppose, at that time held a position not less trustworthy or respected than the City Equitable itself. I therefore do not wish in any way by anything that I say to discharge the auditors from their duties as laid down in the *Kingston Cotton Mill* case; far less do I wish to discharge them from their duty of seeing that securities are held and only accept the certificate that they are so held from a respectable, trustworthy and responsible person, be that person the bank or be it somebody else; but in applying my mind to the facts of this case I am not content to say that simply because a certificate was accepted otherwise than from a bank therefore there was necessarily so grave a dereliction of duty as to make Messrs. Langton & Lepine responsible. I think in the light of the evidence which has been given it is for the auditor to use his discretion and his judgment, and his discrimination as to who he shall trust; indeed I think that is the right way to put a greater responsibility on the auditors.

"If you merely discharge him by saying he accepted the certificate of a bank because it was a bank you might lighten his responsibility. I think he must take a certificate from a person who is in the habit of dealing with, and holding, securities, and who he, on reasonable grounds, rightly believes to be, in the exercise of the best judgment, a trustworthy person to give such a certificate. Therefore I by no means derogate from the responsibility of the auditor, I rather throw a greater burden upon him, but at the same time, I throw a burden upon him in respect of which the test of common sense can be applied, and common business habits can be applied, rather than a rigid rule which is not based on any principle either of business or common sense."

(H) REX V. KYLSANT AND MORLAND. (1931, Acct. p. 109 *et seq.*).

Criminal proceedings were taken against the chairman and the auditor of the Royal Mail Steam Packet Co., Ltd., under the Larceny Act, 1861, the allegation being that the chairman had issued false annual reports to the shareholders *with intent to deceive,* and that the auditor had been guilty of aiding and abetting in the issue of such false reports. Both the chairman and the auditor were acquitted of this charge, but the chairman, on a further charge, was found guilty of publishing a prospectus which he knew to be false in a material particular.

For some years the Royal Mail Co. had incurred actual trading losses, but their published accounts revealed considerable profits available for dividend. This position was largely brought about by the utilisation of taxation and other reserves created in past years and no longer required for the purposes for which they were made. These reserves were secret reserves, inasmuch as they were not disclosed in the accounts, and the only indication of the fact that such reserves were being used as an aid to the profits of the years in question were the words "after adjustment of taxation reserves" included in the omnibus item of income shown to the credit of the published Profit and Loss Account. It was shown that during the years 1921-1927 no less than £5,000,000 taken by the company to the credit of its Profit and Loss Accounts was the result of drawing upon secret reserves or taking credit for such non-recurring items as bonus shares received. It was alleged by the prosecution that the result of such adjustments was to cause shareholders to believe that the company

was trading profitably, whereas in fact it was making losses.

In the course of his opening remarks the Attorney-General said that when an auditor signed accounts, and stated "to the best of my information this Balance Sheet is properly drawn up so as to exhibit a true and correct view of the company's affairs as shown by its books" he was stating something upon which the ordinary investor was entitled to rely.

The auditor was charged under Section 84, Larceny Act, 1861, with aiding and abetting in the circulation of a written statement or account which he knew to be false in a material particular. In this connection, Wright, J., said, in the course of his summing-up—

"What exactly does that mean? The conclusion I have arrived at is this —that it is not limited to a case where you point to a written statement or account and say, 'Here are certain figures and words which are false.' I think that is to narrow unduly the words 'in any material particular.' If it is true in that way it would shut out the type of fraud in connection with written documents and accounts which may be of the utmost importance—*the type of fraud where you have a document, not fraudulent in the sense of what it states, but in the sense of what it conceals or omits.*

"I think the language which is used means more than that. It will cover the case where you have a written statement or account which is false in no specific words or figures which it contains, but which is false in the way in which it may be formed.

"*You may say, referring to every word and every figure, there is nothing false about this or that, but the document as a whole may be false, not because of what it states, but because of what it does* NOT *state and because of what it implies.*

"Of course, that type of falsity, which is indeed the type of falsity in question here, is more difficult to establish than a case where you can point to a specific false word in a sentence. Where the falsity consists in fraudulent design to create a false impression you have got to show affirmatively that there was a deliberate attempt to create a false impression.

"If you have a definite falsehood then that speaks for itself."

Mr. Justice Wright pointed out that the section involved three things—a false written document, knowledge of the falsity by the person who put it forward, and intent to deceive.

Little was said at the trial about the Balance Sheet of the company, the main alegation being that the Profit and Loss Account contained information which was false in that it included "old" reserves without that fact being disclosed.

In his summing-up Wright, J., made the following remarks in connection with secret reserves—

"We have heard a great deal about the keeping of secret reserves, and we have heard a great deal about the commercial troubles which may flow from that practice. We have heard a great deal about what is often done in practice, and it may be reasonably and properly done, but the question may arise some day, and possibly will arise, in some appropriate proceeding, in order to find out and elucidate these very special matters. It was said by a learned judge on one occasion, by way of observation and not by judgment, that a company, that is to say the shareholders, could not complain if the position of the finances of the company was better than the accounts disclosed. That has been quoted from time to time as a justification for this method of keeping reserves secret. But there may be very great evils if those who have the control and management of companies, and who control and manage companies for the benefit of the shareholders who entrust their moneys to companies, have very large portions of the company's assets left in a secret disposition of the managing authority. It may work very well in many cases; no doubt it does. It is a practice which is being followed, no doubt, by many concerns of the highest standing. On the other hand, it may be the subject of almost intolerable abuse. Such a system may be used to cover up negligences, irregularities and almost breaches of faith. It is said to be a matter of domestic concern between the company and the shareholders, but if shareholders do not know and cannot know what the position is, how can they form any view about it at all?"

With regard to the use of the words "adjustment of taxation reserves" Mr. Justice Wright said—

"Is this phrase sufficient? Is it a proper intimation to the shareholder in the year 1926 of what has been going on in the company's affairs, in order to produce year by year, not only debenture interest and the interest, discounts and other things, but the preference dividend and the ordinary dividend?.... I am reminding you, although I am sure you have it in your minds, that it is my duty to remind you of what appears to me to be the first question you have to consider, granting all this, was it false and misleading in all the circumstances to put forward to all the shareholders in the Balance Sheet* merely these words 'adjustment of taxation reserves,' as a warning that these enormous sums were being drawn from these funds, the nature of which I must consider a little later?".

*These words actually appeared in the Profit and Loss Account, not in the Balance Sheet.

In connection with the auditor's position in regard to secret reserves, the Judge said—

"If the accounts from which the dividends were being paid or the expenses were being met were being fed by undisclosed reserves, it seems very difficult to see how an auditor could discharge his duty of giving a true and accurate view of the correct state of the company's affairs without drawing attention to those facts, which were vitally important.

"No doubt an auditor in his important and delicate duties must use a certain amount of discretion, but whatever discretion he may feel justified in exercising, he must remember he is under statutory duty, and he may come under the penalties of law, if he fails in *that* duty...

"The auditor is not concerned with questions of policy, but if he sees that there is something in the accounts to which he ought to draw the attention of the shareholders it is his duty to do so. Either he will not sign the certificate at all or he will sign it with some qualifications such as circumstances require.

"The question is not whether the two defendants or either of them have committed any breach of duty to the company, either as chairman or auditor. If a breach of duty has been committed in connection with the accounts, if there has been any negligence, anything for which the directors or auditor may be liable to the company, then that is a matter directly and entirely beyond your purview and consideration.

"You are not here dealing with questions of civil liability. For civil liability the appropriate remedy is an action for damages."

(1) IN RE THE WESTMINSTER ROAD CONSTRUCTION AND ENGINEERING CO., LTD. (1932, Acct. February, 1932, pp. 203-204).

Held—THAT AN AUDITOR IS GUILTY OF MISFEASANCE WHEN HE FAILS TO DETECT THE OMISSION OF LIABILITIES FROM THE BALANCE SHEET IN CIRCUMSTANCES WHERE THEIR OMISSION SHOULD HAVE BEEN APPARENT. *Held also*—THAT AN AUDITOR IS GUILTY OF MISFEASANCE WHEN HE FAILS TO DETECT THE OVER-VALUATION OF WORK-IN-PROGRESS IN CIRCUMSTANCES WHERE AMPLE EVIDENCE IS AVAILABLE FOR THE PURPOSE OF CHECKING THE ACCURACY OF THE FIGURES GIVEN TO HIM.

This was an action brought by the liquidator of the company against the directors and auditors for the recovery of a dividend paid by the company. The dividend was paid for the year ended 31st March 1928, the profits of that year being shewn by the accounts to be £3,458. It was contended by the liquidator that there had been no profits out of which a dividend could be paid, and that the profit shown by the accounts was created by under-

stating the company's liabilities and overstating the value of work-in-progress. The auditors had also acted as accountants to the company. No charge of dishonesty was made against any of the respondents, the allegation being that they had failed in the proper discharge of their duties.

The claim against the directors was dismissed on the grounds that they had all believed in the Balance Sheet reported upon by the auditors. The action against the auditors succeeded.

In the course of his judgment, Bennett, J., said—

"If the auditor found that a company in the course of its business was incurring liabilities of a particular kind, and that the creditors sent in their invoices after an interval and that liabilities of the kind in question must have been incurred during the accountancy period under audit, and that when he was making his audit a sufficient time had not elapsed for the invoices relating to such liabilities to have been received and recorded in the company's books, it became his duty to make specific enquiries as to the existence of such liabilities and also, before he signed a certificate as to the accuracy of the Balance Sheet, to go through the invoice files of the company in order to see that no invoices relating to liabilities had been omitted. The evidence has established to my satisfaction that no experienced auditor would have failed to ascertain the existence of the liabilities omitted from this Balance Sheet."

With regard to the over-valuation of work-in-progress the expert evidence was that it was the duty of the auditor to check the value at which work-in-progress was shown in the Balance Sheet. The judge stated that he was satisfied that there was ample material in the possession of the company with which the auditor could have tested the accuracy of the figures given to him, and that he was guilty of negligence in failing to make use of such material.

§ 6. Legal Decisions Considered

(A) Liability for Negligence under Common Law.

It has already been pointed out that it is extremely important for the auditor of a private firm to have a clear undersanding with his clients as to the extent of his responsibility. This was illustrated in the case of *Wilde and Others* v. *Cape & Dalgleish* (1897, Acct. L.R. 81), where, owing to the auditors omitting to examine

the pass book, frauds were not discovered. The defence in this case was that an audit of the cash transactions was not part of the original arrangement, but this could not be substantiated, and a settlement was arrived at.

A further instance of the auditor's liability in this connection is to be found in the case of *Smith* v. *Sheard* (1906, 34 Acct. L.R. 65). The defence in this case was that no agreement to perform an audit had ever been made, and that no audit was in fact conducted, with the result that defalcations were not discovered. The defence, however, was not substantiated, and the auditors were held liable, although no certificate was placed by them on the accounts. The absence of such certificate, therefore, though it may have an important bearing on the result, will not of itself be sufficient to free the auditor from liability.

In the case of *Chas. Fox & Son* v. *Morrish Grant & Co.* (1918, 59 Acct. L.R. 29), the accountants were employed to check the books and prepare accounts, but they did not examine the pass book, and were held liable for damages in consequence of defalcations arising which would have been discovered had the pass book been examined. The defence was that no audit was undertaken, and that it was not necessary to examine the pass book in checking the mathematical accuracy of the books and preparing accounts. The Court held, however, that the checking of the books and the preparation of accounts in the circumstances in question, where "Cash at Bank" was inserted in the Balance Sheet by the accountants, implied a duty on their part to see that this asset actually existed.

In the case of *Martin* v. *Isitt* (1898, Acct. L.R. 41), a similar fraud took place. One of the terms of the contract for the audit was that it should be a monthly one, but although the fraud commenced in November 1896, it was not discovered by the auditors until April 1897, thus enabling the defalcations to be continued during that period. The defence was that the delay was occasioned by the state of the books, but a settlement was ultimately arrived at.

In the case of *Maritime Insurance Co., Ltd.*, v. *William Fortune & Sons* (1931, Acct. L.R. pp. 44-51), a claim was made against accountants for the non-discovery of defalcations. The defendants had certified the monthly returns made by a branch of the

plaintiffs, and had at no time qualified their certificate in any way. It was alleged that not one of these returns accorded with the true facts, and had the accountants applied at least one of a number of tests (in particular an examination of the counterfoil paying-in-slips) they would have discovered the fraud. The defendants contended that they had been employed not to audit the books of the branch but merely to see that the monthly returns were correctly made out from the books kept by the company's servant, and that, therefore, unless they had reason to be suspicious it was not their duty to impose tests upon the accuracy of the records kept. Mr. Justice Roche stated in the course of his judgment that, in his view, according to the terms of the arrangements made between the accountant and the client, the defendant's duties were limited to examining the books, seeing that they correspond with the books that had to be kept, and in that sense seeing that they were adequately kept, and seeing that they were adequately summarised in the return to the head office. His Lordship also stated that there was no doubt that had the accountants' suspicions been aroused, it would have been their duty to report upon the matter, but in his view there was nothing which excited or ought to have excited their suspicions, and the claim therefore failed.

Another case in which the charge of negligence against accountants was not substantiated was that of *Leech* v. *Stokes* (1937, 81 Acct. L.R. 87), in which a claim was made against a firm of chartered accountants for damages for alleged negligence and breach of duty. The facts in this case were that the accountants had failed to detect misappropriations by the cashier of a firm of solicitors, of considerable amounts of rents collected by them for clients. No proper books of account were kept, there being no Cash Book nor a Clients' Ledger. The only book available was a Costs Furnished Book in which were entered particulars of the costs charged to clients and weekly summaries of the firm's expenses. From these particulars the accountants prepared Profit and Loss Accounts, but no Balance Sheets. On behalf of the defendants it was alleged that they were merely instructed to prepare a return of profits of the firm for income tax purposes, and that no investigation of the books was necessary or required for that purpose. Accordingly, they did not verify the transac-

tions, nor carry out anything in the nature of an audit, neither was it possible, from the material available, to prepare Balance Sheets. The first year's Profit and Loss Account was certified by the accountants to be in accordance with the books "subject to our report of this date," which was in the following terms:

> We have pleasure in enclosing Profit and Loss Account for the year ended 5th April 1928. Costs and Agency Fees: This total has been compiled from the Costs Furnished Book, which, we are informed, includes all costs and fees furnished during the year. In accordance with your instructions, we have excluded the sum of £655 1s. 7d. as representing costs, etc., earned prior to 5th April 1927, the date of the commencement of the present partnership. Office Outlay: The total expenditure during the year as shown by the weekly summaries amounted to £1,235 18s. 5d., of which the sum of £450 4s. 2d. represented sundry disbursements charged to clients. These latter have been deducted from the costs and agency fees as shown in your statements, leaving office expenditure amounting to £785 14s. 3d. If you approve of the account, we shall be pleased to forward a copy to the Inspector of Taxes on hearing from you.

The plaintiffs claimed that, as auditors, the firm of accountants should have verified the records before preparing the Profit and Loss Account, and should have prepared a Balance Sheet, and had they done so the defalcations would have been revealed.

In the course of his judgment, the judge stated that he was satisfied that a Balance Sheet could not have been prepared in the absence of a Clients' Ledger and Cash Book, and that if a Balance Sheet had been necessary, apart from being a reasonable and a desirable requirement, which might or might not have been dispensed with, it would have been necessary to write up the Cash Book and a Clients' Ledger. The accountants advised their clients that proper books ought to be kept and a Balance Sheet prepared, and even provided a set of books in which they made the opening entries, but when they next attended, the Clients' Ledger had not been written up, on the grounds that the cashier was overworked.

His Lordship found that "the instructions given to the defendant firm were to prepare a report of profits for the Inspector of Taxes" and that "in this case there was no proper book-keeping material available for the preparation of a Balance Sheet," and "that there was no actionable negligence or breach of duty on the part of the defendants in any of the matters relied upon."

In the case of *Armitage* v. *Brewer and Knott* (1932 Acct. p. 836), the auditors were found guilty of negligence consisting of their failure to detect defalcations perpetrated by manipulation of the wages records and petty cash vouchers. The case, which did not concern the audit of a limited company, turned very largely upon the exact arrangement made between the auditor and the client as to the work to be performed. In the course of his judgment Talbot, J., said:

"The documents at the beginning set out that the defendants would vouch all payments with receipts in petty cash, check calculations and additions of all wage sheets, check totals of wage sheets into wages book and check weekly totals, with other detailed provisions, and accountants undertaking duties of that kind could not be heard to excuse themselves on the ground that this or that was a small matter; they undertook a vigorous check, and they did so because that is what their client wanted."

In the course of the hearing Talbot, J., declared "that it was the duty of auditors to be suspicious, that was what they were there for. If everybody was honest and careful, there would be no need for auditors." These remarks have been the subject of much comment in view of the judgment of Lindley, L.J., in *The Kingston Cotton Mill* case. It must, however, be remembered that a judgment must be read in conjunction with all the facts of the case; the plaintiff in the *Armitage* case was shown to have told the auditors at the time of their appointment that he wanted protection against petty frauds and the auditors undertook the work and gave the plaintiff the reassurances that he frequently asked for.

It is interesting to note that in this case the auditors were held responsible for the amount of the defalcations which arose subsequent to their failure to detect fraud with regard to petty cash in an earlier period. In a leading article in *The Accountant* referring to the case, it was stated:

"As we have said, however, the case gives a footing disadvantageous to the profession for applying the principle of consequential damage to audit claims, and one of our correspondents has pointedly stated a case of pure consequential damage, which merits careful consideration. Thus, if an auditor omits to detect a defalcation by an employee and in the following year, before there is a chance of any further audit, the employee, emboldened by having escaped detection, embezzles a larger sum, is the

auditor liable both for the original embezzlement which he failed to detect and for the subsequent loss to the employer as well?

"So far as we are aware there is no exact professional precedent . . . Addressing ourselves then, with such help as we can get, to the questions set to us, the answer to our minds depends upon the character of the initial error or omission. A mere mistake will not render a professional man liable for its consequence, but if the negligence was of the same type as was alleged in the case under discussion, *i.e.*, omitting to detect a fraud which by the exercise of reasonable care an accountant would have detected, then we are inclined to think a jury would take into account the consequential loss in their award of damages. . ."

The whole question in these cases is as to the precise terms of the agreement, and unless the limitations of responsibility are very clearly defined between the parties, the accountant or auditor should regard himself as under as much responsibility as if he were conducting a complete audit.

In 1955 the Council of the Institute of Chartered Accountants in England and Wales issued the following statement to members on the subject of accountants reports on the accounts of sole traders and partnerships:

1. Practising members of the Institute have clients, such as sole traders and partnerships, who are not subject to statutory requirements relating to the preparation and audit of accounts. There is considerable diversity of practice among members in regard to the manner in which they associate their names with accounts they prepare or audit for such clients. Some members issue accounts in folders bearing their name and qualification, but without giving any indication of the capacity in which they have acted or the nature of the duties undertaken. Other members give an indication by means of a statement on the face of the accounts or by a separate report to the client.

2. The work which a member does is dependent upon the terms of his appointment by the client who may, on the ground of expense or otherwise, have limited the scope of the work to be done; it is also dependant upon the adequacy of the records kept by the client. There is a great diversity of circumstances and therefore uniformity of practice is neither possible nor desirable.

3. Such diversity provides scope for misunderstanding as to the significance of the association of the member's name with the accounts and any serious misunderstanding may damage the interests of the client or the professional reputation of the member. Accordingly the Council considers it desirable to issue this statement for the guidance of members.

4. It is important that a client (including every partner in a partnership) should understand the degree of responsibility which the member

accepts in relation to accounts or similar financial statements. Moreover, the accounts will normally be submitted, either by the client or on his behalf by the member, to the Inland Revenue and may be made available by the client to other third parties. It is desirable that anyone who sees the accounts should be aware of the nature of the responsibility which the member has undertaken towards his client.

5. The Council is therefore of the opinion that when a member allows his name to appear on, or be otherwise associated with, a balance sheet and profit and loss account, or similar financial statements, he should give a clear indication of the significance of the association of his name with the accounts. This indication may be given by means of a statement on the face of the accounts or by including thereon a reference to a separate report to the client.

6. The choice of method and the terms of the member's statement or report to the client are for him to determine in the circumstances relevant to each client. In reaching a decision the essential matters for the member to consider are:

(*a*) The capacity in which he has acted.
(*b*) Whether the records appear to be reliable and adequate in relation to the nature of the business.
(*c*) Whether he has been able to obtain necessary information and satisfactory explanations.
(*d*) Whether the effect of the client's instructions is to impose material limitations on the work to be undertaken; in particular whether the instructions involve the omission of work which the member would need to do in order to form an opinion as to whether the accounts show a true and fair view.

7. Where the member has been appointed as auditor, he should state that *he has audited the accounts and also state whether in his opinion they present a true and fair view subject to any reservations he may consider necessary.*

8. In the great majority of cases the member will not have been appointed as auditor, although he may often carry out considerable auditing work in preparing the accounts. For such clients he should state that *he has prepared the accounts and should then make such observations as will ensure that the association of his name with the accounts does not imply that they can be regarded as more reliable than the circumstances warrant.* The following examples indicate how this general principle can be applied in three broad types of circumstances:

(*a*) If the member is able to do so, having carried out sufficient auditing work to his satisfaction, he could state that he has prepared the accounts and in his opinion they present a true and fair view, subject to any reservations he may make. Such an opinion should not be expressed if the reservations are so extensive as to vitiate the opinion.

(*b*) If the client's instructions involve the omission of work which the member would need to do in order to form an opinion as to whether the accounts show a true and fair view but the records are *prima facie* satisfactory, he could appropriately state that he has prepared the accounts from the records and other information supplied by the proprietor but without verification thereof (or without verification of specified matters).

(*c*) If, however, the records are materially inadequate or otherwise unsatisfactory the member should state that he has prepared the accounts from records and other information supplied by the proprietor and should then specify the matters in respect of which he has been unable to satisfy himself, making clear the significance thereof on the reliability of the accounts.

9. Where the member finds it necessary to make lengthy reservations it will normally be found convenient to do this by means of a separate report to the client with a reference thereto on the face of the accounts indicating that they are to be read in conjunction with that report. Where the member is able to make a short statement it will normally be more convenient and appropriate for this to appear on the face of the accounts.

10. If the accounts of a sole trader do not themselves sufficiently indicate that they are confined to dealing with the position and results of a particular business carried on by that person, the member's statement or report should contain such an indication.

The failure to detect defalcations was the occasion of the case of the *Astrachan Steamship Company, Ltd. and Others* v. *Harmood Banner & Son* (1900, Acct. L.R. 49), where an action was brought for damages for alleged negligence, which was ultimately settled in favour of the plaintiffs.

In the case of the *London Oil Storage Company, Ltd.* v. *Seear, Hasluck & Co.* (1904, Acct. L.R. 30, 93), it was held that it is the duty of the auditor of a company to take proper steps to verify the existence of assets. The point arose in connection with the verification of the petty cash balance, which was shown by the books to be £796, but the amount in hand was actually found to be only £30. The auditor contended that his duties ended when he had seen that the entries in the books created an asset. The absurdity of such a contention is manifest, and it was found that the auditor had committed a breach of duty in not vouching the existence of the cash in hand. The damages against the auditor were assessed at only five guineas, the jury stating that in their opinion the directors had been guilty of gross negligence in allowing so large a sum to remain in the hands of the petty cashier.

This is important, as illustrating the point that the auditor is only liable for such damage as flows directly from the act of negligence complained of.

An auditor has been held liable for failing to detect fraudulent suppression, or carrying over of invoices for goods purchased, the Court holding in the particular circumstances that he ought to have discovered the fraud by the exercise reasonable skill and diligence. This portion of the audit was not performed by the auditor himself, but by his clerks, and the Court stated that although the auditor is bound to give reasonable care and skill, this can also be exercised by his deputy. At the same time, if the deputy fails in his duty, the responsibility falls upon the auditor; and where such failure is due to lack of supervision on the part of the auditor, in allowing the details of the audit to be carried out in a mechanical way by his clerks, he must suffer the consequences (*The Irish Woollen Company, Ltd.* v. *Tyson & Others, supra*).

The question as to whether an auditor sustains any civil liability in damages to third parties to whom certified accounts have been submitted, which have been relied upon by such parties in granting loans or credits to the client, was considered in the case of *Candler* v. *Crane, Christmas and Company* (1950, 211 The Law Times, p. 96). In this case the managing director of a company had instructed the defendants, a firm of accountants and auditors, to prepare the company's accounts and it was known to the defendants that such accounts would be used to induce the plaintiff to invest money in the company. The draft accounts were shown to the plaintiff in the presence of the defendant's clerk and, relying on their accuracy, the plaintiff subscribed for shares in the company. The accounts in question had been prepared negligently by the defendants, but without fraud, and on the liquidation of the company the plaintiff lost the money he had invested. The plaintiff sought to recover damages from the defendants for negligence or, alternatively, for breach of their duty as the company's auditors to give the plaintiff, as a shareholder, accurate information. It was held by the Court of Appeal that there was no contractual or fiduciary relationship between the parties and that, therefore, the plaintiffs could not maintain an action for negligence against the defendants. It was further held that as the plaintiff had made his investment before the re-

lationship of shareholder and auditor became operative no damage flowed from the breach of any such duty owed by the defendant to the plaintiff in that capacity.

The decision in the *Candler* case was also followed in the more recent case of *De Savary* v. *Holden, Howard & Co.* (The 'Times', Law Report, 11th January, 1960).

In the latter case the plaintiff was the managing director and virtual owner of three limited companies, all of which were heavily indebted to the bank. The bank was anxious to reduce this indebtedness, but the plaintiff wanted to extend his credit facilities. At the suggestion of the bank the plaintiff agreed to pay the cost of an independent investigation of his companies' affairs by the defendants, a well-established and reputable firm of accountants.

Defendants duly prepared accounts for the companies for the five months ending 31st May, 1950, and reported to the bank. The accounts showed that the companies had made a net profit during that period of about £14,000. Plaintiff contended that in preparing these accounts the defendants had been negligent, in that the figures for stock and work-in-progress shown therein were grossly inflated, and the figure of profit was fictitious; in fact, the companies were trading at a loss.

After considering the facts, Mr. Justice Barry said that there was a complete lack of any evidence that the defendants were told that their accounts were to be used or relied on by the plaintiff for any purposes. The accountants took instructions only on behalf of the bank. They were the bank's accountants and acted in that capacity alone. The fact that the bank caused the plaintiff to pay for the defendants' services had nothing to do with it. Had the plaintiff not paid the defendants' fees the bank would have been responsible.

In the absence of a contractual relationship between the plaintiff and the defendants his Lordship was bound by the judgment in the Court of Appeal in *Candler* v. *Crane Christmas & Co.* (1951). A careless misstatement, acted on by another to his detriment, was not actionable in the absence of a contract or a fiduciary relationship. There was no such relationship here. It followed that the defendants owed no duty to the plaintiff and the negligence claim could not be sustained.

Although the issue of whether the defendants had been negligent was therefore immaterial, his Lordship thought it right to express his views on the point. The accounts contained a serious misstatement of the amount of the stock in hand and work-in-progress at two of the companies, and the plaintiff alleged that these errors were *prima facie* evidence of negligence. His Lordship said that was not so where much of the information upon which the accounts were based emanated from the books of the plaintiff's companies. To establish negligence it was necessary to show either that the accounts were carelessly prepared or that the accountants were under an obligation to satisfy themselves that the companies' books represented the true position of the companies. The trouble was that the records of the companies were in fact wrong and did not give a correct picture of the stock. It followed that no negligence had been established. It will be appreciated that the accountants in this case were not acting as auditors.

(B) Liability for Misfeasance under the Companies Act, 1956.

The term "misfeasance" implies a breach of trust or duty. The auditor of a company, therefore, commits a misfeasance if he is negligent in the performance of his duties, but he cannot be made liable in damages under Section 543 of the Companies Act, 1956, in the event of winding-up, unless such misfeasance has directly resulted in damage to the company.

This section merely provides a more expedient form of procedure and creates no substantial new safeguard for the interests of the company. Proceedings under the section must accordingly be founded upon circumstances which would give rise to a claim against the auditors under the general law.

In the *London & General Bank* case it was proved that the auditor was aware of the serious position of the company, owing to the fact that large sums advanced to customers on loan and current accounts were insufficiently secured, and he was also aware that interest on such advances was taken to the credit of the Profit and Loss Account, although such interest had not been paid or provided against. He reported upon this state of affairs

to the directors, but failed to induce them to make the necessary alterations in the accounts, or to refrain from paying a dividend. Lindley, L.J., said that taking the Balance Sheet, Certificate, and Report together, the auditor stated the true financial position of the the bank to the directors, and if this report had been laid before the shareholders he would completely have discharged his duty to them. The misfeasance in this instance consisted in not placing this information before the shareholders. It was pointed out by the learned judge that information, and means of information, are not equivalent terms, and that a person whose duty it is to convey information to others does not discharge that duty by simply giving them so much information as is calculated to induce them, or some of them, to ask for more. An auditor who adopts such a course as this does so at his peril, and runs a very serious risk of being held judicially to have failed to discharge his duty. It is clearly the auditor's duty, therefore, in cases where the Balance Sheet is not in order, to report fully to the shareholders.

The auditor is not concerned whether the business of the company is prudently or impurdently conducted, and it is no part of his duty to give advice either to directors or to shareholders. Whether dividends are properly or improperly declared is immaterial to the auditor, provided he discharges his own duty to the shareholders.

The auditor's duty is not merely confined to verifying the arithmetical correctness of the Balance Sheet, and comparing it with the books. He must make proper enquiries to see that the books of the company themselves show the true position; at the same time, he is not bound to do more than exercise reasonable care and skill. He is not an insurer and he does not guarantee that the books do correctly show the true position of the company's affairs or that the Balance Sheet is accurate according to the books. The auditor must be honest, that is, he must not certify what he does not believe to be true, and he must exercise reasonable care and skill before he believs that what he certifies is true.

In the case of *In re the Kingston Cotton Mill Co., Ltd.*, No. 2 (*supra*), the stock-in-trade had been deliberately manipulated, and the auditors accepted the certificate of the manager as to the correctness thereof, without checking the stock in detail. The Court of Appeal held that they were not guilty of negligence in

so doing; that it is not the duty of the auditor to take stock, and that he is entitled to rely upon other people for details of this nature. *In the absence of suspicious circumstances,* the auditor can rely upon the representations of trusted officials; he is justified in believing tried servants of the company, in whom confidence is placed by the company.

Lopes, L.J., said that auditors must not be held liable for not tracking ingenious and carefully-laid schemes of fraud, when there is nothing to arouse their suspicion, and when those frauds are perpetrated by tried servants of the company, and are undetected for years by the directors.

This decision is valuable, as defining, to some extent, the liability of the auditor, but it should be observed that the question as to whether or not the auditor may be held to have been negligent, will depend entirely upon the circumstances in each case; that this is so is confirmed by the decision in *Henry Squire* (*Cash Chemists, Limited*) v. *Ball, Baker & Co.,* and *Mead* v. *the same* (1911, Acct. L.R. 44, 25) and, in the Court of Appeal, *Mead* v. *Ball, Baker & Co.* (1911, Acct. L.R. 45, 33).

It was shown in the course of this case that stock sheets had been falsified for years, and that they contained numerous alterations, which, it was argued, should have caused suspicion. It was held that the auditors had relied upon the certificate of a responble official, and their suspicions had not been aroused in the course of their investigations, and that *in the given circumstances* there was nothing necessarily to arouse the suspicions of an auditor who had exercised the skill necessary in conducting the audit.

It has been shown clearly, however, by *In re The Westminster Road Construction and Engineering Co., Ltd.,* that an auditor must make the fullest use of all material available to him, and although it has been decided that he is not a stocktaker, and presumably not a valuer of work-in-progress, he will be guilty of negligence if evidence is reasonably available from which the overvaluation of work-in-progress could be detected and he fails to utilise such evidence.

It has already been pointed out that as a result of the disclosures in the American case of *McKesson and Robins* (on page 137 *ante*) the accountancy profession in the U.S.A. has adopted as part of normal auditing practice some form of test check of

the actual physical stock.

Mere extract from the decided cases dealing with the auditor's duty with regard to stock must not be taken too literally and applied to the verification of this asset irrespective of circumstances. An auditor cannot rely upon the certificate of a trusted official in respect of stock without making *any* attempt to check its accuracy, particularly as the asset is one known to be susceptible of facile manipulation, and the auditor might be contenting himself with the assurance of a person, who was himself a party to the manipulation. It is realised that the verification of stock is a matter of very considerable difficulty and that in but a few cases could an auditor make such an investigation as would enable him to be assured, without any possible doubt, of its accuracy. In all cases, however, some tests are available to the auditor and of these he must take the fullest advantage; if the tests made reveal no suspicious circumstances then, and only then, may he accept a certificate from some trusted official who is competent to give it. The tests which may in general be made have been set out in Chapter V, § 4(c).

Similar remarks must be held to apply to other assets as is shown by the case of *Arthur E. Green & Co.* v. *The Central Advance & Discount Corporation Ltd.*

It is the duty of an auditor of a limited company to make himself acquainted with his duties under the Articles of the company and under the Companies Act for the time being in force, and this particularly applies to the passing of payments made by the directors *ultra vires*. Where such payments have been made, the auditor must be particularly careful to refer to them in his report to the members, since if this is not done it might be held that the company had suffered loss by reason of its having been unable to recover the amounts improperly paid away.

In the case of *In re Bolivia Exploration Syndicate* (1913, 30 T.L.R. 146), where circumstances of this nature arose, but where the auditors had pointed out the facts or they had been disclosed on the face of the accounts, it was held that damage to the company had not been established and that the auditors had not been guilty of any breach of duty.

Again, in *Re S. P. Catterson & Sons Ltd.* (1937, 81 Acct. L.R. 62) where considerable defalcations by a servant of the company

had not been revealed by the audit, the auditors were acquitted of liability for negligence on the grounds that they had pointed out to the directors that the system of recording certain sales was unsatisfactory, and had recommended improvements, but these recommendations were not adopted. Mr. Justice Bennett, in reviewing the responsibility of the auditors, stated that the primary responsibility for the accounts of a company is with the directors, and in this case they were not a satisfactory team. He stated, "I have no doubt as to where the primary responsibility for finding out the defalcations of this man Spicer lies. It lies upon the shoulders of the man whose duty it was, as a director of this company, to collect from Spicer the cash that he received. If that man had done his duty in any degree at all, the frauds could not have been perpetrated in the way in which they were perpetrated." The Judge came to the conclusion that the auditor was an honest man trying to do his duty, and that in view of all the facts of the case and the audit notes, the applicant had quite failed to satisfy him that there was any negligence in respect of the matters charged.

The case of In *re The City Equitable Fire Insurance Co., Ltd* (*supra*) is one of the most complicated and important cases which have yet been fought under what is now Section 333 of the English Companies Act, 1948 (corresponding to Section 543, Companies Act, 1956), and the detailed judgments are worthy of close study. The Court of Appeal followed the principles laid down in earlier cases as to the duties of auditors, and as full extracts from the judgments have already been given, there is no need to recapitulate the facts here.

The main point related to the auditor's duties in connection with the custody and inspection of securities. In this case the auditors did not inspect the securities which purported to be in the hands of the company's brokers, but accepted from the brokers certificates that they held them, though in fact the securities either did not exist or if they did exist had been pledged. At the time the certificates were given the auditors had no reason to doubt the integrity and standing of the brokers in question.

Considerable arguments arose on the question as to whether the auditors were entitled to accept a certificate from a reputable bank, and also whether in any circumstances a certificate should

be accepted from stockbrokers or other persons.

The Court of Appeal declined to lay down any hard-and-fast rule, but indicated that the auditor is entitled, in his discretion, to accept a certificate from a person who is in the habit of dealing with and holding securities and who, in the exercise of his best judgment, he considers a trustworthy person to give such a certificate. If the auditor is not satisfied on these points, he should require the company at once to obtain delivery of the securities, and failing this he should report the matter to the members.

Notwithstanding this, it would appear to be desirable that the auditor should actually inspect the securities in the custody of third parties wherever this is practicable, and, where this is not done, *should state in his report that he has accepted a certificate.* Where a certificate is relied on, it should state that the securities are held free from any charge or encumbrance.

(c) CRIMINAL LIABILITY

There is no doubt that although the auditor of the *Royal Mail Steam Packet Co.* was found not guilty of the charges brought against him, auditors were given serious warning of the dangers involved if full information was not given to the shareholders of the utilisation of secret reserves. The *Royal Mail Company* was a chartered company, but this did not affect the principle involved.

No doubt, however, any longer exists as to the information to be provided by the Profit and Loss Account as the result of the passing of the Companies Act, 1956.

§ 7. Unlawful Acts or Defaults by an Accountant's Clients

A professional accountant has access to much information of a private character and, on occasions, during the course of his duties, he may acquire knowledge which indicates that his client has, or may have been guilty of some unlawful act or default.

Where the offence constitutes a felony, the accountant should obtain legal advice as to the action he should take.

Where, however, the offence is a misdemeanour, the position is different, as the accountant has no possible duty to act as informer and it would be a breach of confidence if he were to use knowledge obtained in his professional capacity for such a purpose.

Taxation frauds are the most likely misdemeanours to be encountered by the professional accountant in the course of his practice and in this context the accountant should carefully note Section 278 of the Income-tax Act, 1961 which is reproduced hereunder:

"If a person abets or induces in any manner another person to make and deliver an account, statement or declaration relating to any income chargeable to tax which is false and which he either knows to be false or does not believe to be true, he shall be punishable with simple imprisonment which may extend to six months or with fine which may extend to one thousand rupees or with both."

Where a return of income is prepared by an authorised representative, Rule 12A, Income-tax (Amendment) Rules, 1962, provides as under:

12A. Preparation of return by authorised representative.— Every authorised representative of an assessee, being an authorised representative specified in clause (iii) or clause (iv) or clause (v) or clause (vi) or clause (vii) of subsection (2) of section 288, who has prepared the return of income furnished by the assessee shall, either before making an appearance before the Income-tax Officer having jurisdiction to assess that assessee, or immediately after making such appearance, furnish to that officer—

(a) particulars of accounts, statements or other documents supplied to him by the assessee for the preparation of the return of income; and

(b) where the authorised representative has for the purpose of preparation of the return of income carried out any examination of such accounts, statements or documents, a report on the scope and results of such examination.

While giving a report on the scope and result of examination of accounts, statements or documents, the authorised representative should exercise ample care to limit his report only to those matters in respect of which he has conducted *adequate* examination to warrant giving such a report. As such examination is for a specific purpose, it is advisable to state the exact scope of

examination carried out by him. He should take care to see that he does not take upon himself undue responsibility in respect of points of law, where different interpretations are possible or points of fact in respect of which different inferences are possible.

Section 278 of the Income Tax Act, 1961, imposes criminal liability on the authorised representative and prescribes imprisonment and fine or both, in case the authorised representative is found guilty of abetting or inducing an assessee in filing a false account, statement or declaration which he knows to be false or does not believe to be true. Hence, while giving such report, the authorised representative must confine himself only to those points in respect of which it is possible for him and it is *competent* for him to express an opinion.

The following are examples of other misdemeanours which the practising accountant may encounter in the course of his duties: the fraudulent conversion by trustees and others entrusted with the ownership of property for special purposes; frauds by directors and officers of companies; falsification of accounts; a bankrupt's failure to keep proper books of account; share pushing; fraudulent trading; obtaining property by false pretences; offences against Control regulations governing prices, quotas and licences; offences in respect of sales tax; the payment or receipt of bribes.

A practising accountant acting in a professional capacity, has no responsibility to ascertain whether a client is conducting his affairs in an unlawful manner, but if he becomes aware that a client has committed offiences of the kind mentioned in the preceding paragraph he must, in the opinion of the Institute of Chartered Accountants in England and Wales (which has issued a statement on the subject for the guidance of its members), consider the following points:

(*i*) He must not do anything to assist the client to commit any criminal offence.

(*ii*) Whether the possible consequences of the offence are such as to prevent the accounts which he is engaged in preparing or auditing from giving a true and fair view and, therefore, call for appropriate reservations in his report on such accounts.

(*iii*) Whether in all the circumstances he is prepared to continue to act for the client.

Special considerations apply in connection with limited companies, as the auditor's "client" is the company and not the directors. If, however, it becomes necessary for the auditor to make reservations in his report, the reservations should be in such terms as will indicate clearly the respects in which he is unable to satisfy himself on the matters on which he is required to express an opinion under Section 227 of the Companies Act, 1956, even though the result will be to disclose to the shareholders and others who may see the accounts the fact that an offence has been committed.

If a practising accountant has reason to suspect, but has no actual knowledge, that a client has committed some offence within the scope of the matters on which the accountant acts for him, he should make such enquiries as he thinks are likely to confirm or remove his suspicions. If his suspicions are confirmed, the accountant must act in accordance with the advice outlined above, but if confirmation cannot be obtained but his suspicions remain, the accountant may feel that he would rather terminate his association with the client.

§ 8. Professional Misconduct

(A) Definition

For the purposes of the Chartered Accountants Act, 1949, the expression "professional misconduct" is defined under Section 22 of the said Act which provides as under:

> "For the purposes of this Act, the expression "professional misconduct" shall be deemed to include any act or omission specified in any of the Schedules, but nothing in this section shall be construed to limit or abridge in any way the power conferred or duty cast on the Council under sub-section (*1*) of section 21 to inquire into the conduct of any member of the Institute under any other circumstances."

The First and the Second Schedules to the Chartered Accountants Act, 1949, are as under:

THE FIRST SCHEDULE

(*See sections* 21(4) *and* 22)

PART I

Professional misconduct in relation to chartered accountants in practice.

A chartered accountant in practice shall be deemed to be guilty of professional misconduct, if he—

(1) allows any person to practice in his name as a chartered accountant unless such person is also a chartered accountant in practice and is in partnership with or employed by himself;

(2) pays or allows or agrees to pay or allow, directly or indirectly, any share, commission or brokerage in the fees or profits of his professional business, to any person other than a member of the Institute or a partner or a retired partner or the legal representative of a deceased partner;

Explanation.—In this item "partner" includes a person residing outside India with whom a chartered accountant in practice has entered into partnership which is not in contravention of item (4) of this Part.

(3) accepts or agrees to accept any part of the profits of the professional work of a lawyer, auctioneer, broker or other agent who is not a member of the Institute;

(4) enters into partnership with any person other than a chartered accountant in practice or a person resident without India who but for his residence abroad would be entitled to be registered as a member under clause (v) of sub-section (1) of section 4 or whose qualifications are recognised by the Central Government or the Council for the purpose of permitting such partnerships, provided that the chartered accountant shares in the fees or profits of the business of the partnership both within and without India;

(5) secures, either through the services of a person not qualified to be his partner or by means which are not open to a chartered accountant, any professional business;

(6) solicits clients or professional work either directly or indirectly, by circular, advertisement, personal communication or interview or by any other means;

(7) advertises his professional attainments or services, or uses any designation or expressions other than chartered accountant on professional documents, visiting cards, letter heads, or sign boards, unless it be a degree of a University established by law in India or recognised by the Central Government or a title indicating membership of the Institute of Chartered Accountants or of any other institution that has been recognised by the Central Government or may be recognised by the Council;

(8) accepts a position as auditor previously held by another chartered accountant or a restricted State auditor without first communicating with him in writing;

(9) accepts an appointment as auditor of a company without first ascertaining from it whether the requirements of section 226 of the Companies Act, 1956, in respect of such appointment have been duly complied with;

(10) charges or offers to charge, accepts or offers to accept in respect of any professional employment fees which are based on a percentage of profits or which are contingent upon the findings, or results of such employment, except in cases which are permitted under any regulations made under this Act;

(11) engages in any business or occupation other than the profession of chartered accountants unless permitted by the Council so to engage;

Provided that nothing contained herein shall disentitle a chartered accountant from being a director of a company, unless he or any of his partners is interested in such company as an auditor;

(12) accepts a position as auditor previously held by some other chartered accountant or a restricted State auditor in such conditions as to constitute undercutting;

(13) allows a person not being a member of the Institute or a member not being his partner to sign on his behalf or on behalf of his firm, any balance-sheet, profit and loss account, report or financial statements.

PART II

Professional misconduct in relation to members of the Institute in service.

A member of the Institute (other than a member in practice) shall be deemed to be guilty of professional misconduct, if he being an employee of any company, firm or person—

(*a*) pays or allows or agrees to pay directly or indirectly to any person any share in the emoluments of the employment undertaken by the member;

(*b*) accepts or agrees to accept any part of fees, profits or gains from a lawyer, a chartered accountant or broker engaged by such company, firm or person or agent or customer of such company, firm or person by way of commission or gratification;

(*c*) discloses confidential information acquired in the course of his employment except as and when required by law or except as permitted by the employer.

PART III

Professional misconduct in relation to members of the Institute generally.

A member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he—

(1) includes in any statement, return or form to be submitted to the Council any particulars knowing them to be false;

(2) not being a fellow styles himself as a fellow;

(3) does not supply the information called for, or does not comply with the requirements asked for, by Council or any of its Committees.

THE SECOND SCHEDULE

[*See sections* 21(5) *and* 22]

PART I

Professional misconduct in relation to chartered accounts in practice requiring action by a High Court.

A chartered accountant in practice shall be deemed to be guilty of professional misconduct, if he—

(1) discloses information acquired in the course of his professional engagement to any person other than his client, without the consent of his client or otherwise than as required by any law for the time being in force;

(2) certifies or submits in his name or in the name of his firm a report of an examination of financial statements unless the examination of such statements and the related records has been made by him or by a partner or an employee in his firm or by another chartered accountant in practice;

(3) permits his name or the name of his firm to be used in connection with an estimate of earnings contingent upon future transctions in a manner which may lead to the belief that he vouches for the accuracy of the forecast;

(4) expresses his opinion on financial statements of any business or any enterprise in which he, his firm or a partner in his firm has a substantial interest, unless he discloses the interest also in his report;

(5) fails to disclose a material fact known to him which is not disclosed in a financial statement, but disclosure of which is necessary to make the financial statement not misleading;

(6) fails to report a material mis-statement known to him to appear in a financial statement with which he is concerned in a professional capacity;

(7) is grossly negligent in the conduct of his professional duties;

(8) fails to obtain sufficient information to warrant the expression of an opinion or his exceptions are sufficiently material to negate the expression of an opinion;

(9) fails to invite attention to any material departure from the generally accepted procedure of audit applicable to the circumstances;

(10) fails to keep moneys of his client in a separate banking account or to use such moneys for purposes for which they are intended.

PART II

Professional misconduct in relation to members of the Institute generally requiring action by a High Court.

A member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he—

(i) contravenes any of the provisions of this Act or the regulations made thereunder;

(ii) is guilty of such other act or omission as may be specified by the Council in this behalf, by notification in the Gazette of India.

(B) PROCEDURE

Section 21, Chartered Accountants Act, 1949, provides that where on receipt of information or complaint the Council is *prima facie* of the opinion that a member has been guilty of professional or other misconduct, the Council must refer the case to the Disciplinary Committee, which should hold such inquiry and in such manner as may be prescribed and report the results of its inquiry to the Council.

If the Council, on receipt of such report, finds that the member of the Institute is not guilty it must record its finding accordingly and direct that the proceedings be filed or that the complaint be dismissed.

If the Council, on receipt of such report, finds that the member is guilty of professional misconduct specified in the First Schedule, it may, after giving a hearing to the member, make any of the following orders, namely:

(*a*) reprimand the member;

(*b*) remove the name of the member from the Register for such period, not exceeding five years, as the Council thinks fit but where it appears to the Council that the member ought to be removed for a period exceeding five years or permanently it cannot make such order but must forward the case to the High Court with its recommendations thereon.

Where the misconduct in respect of which the Council has found any member guilty of misconduct other than as is referred to in Section 21(4) of the Act i.e. misconduct other than that specified in the First Schedule, it must forward the case to the High Court with its recommendations thereon.

The High Court will cause notice of the hearing to be given to the member, the Council and to the Central Government, and afford them an opportunity of being heard and thereafter, it may make any of the following orders:

(*a*) direct that the proceedings be filed, or dismiss the complaint, as the case may be;
(*b*) reprimand the member;
(*c*) remove him from membership of the Institute either permanently or for such period as the High Court thinks fit;
(*d*) refer the case to the Council for further inquiry and report.

For the purposes of Section 21, "member of the Institute" includes a person who was a member of the Institute on the date of the alleged misconduct although he has ceased to be a member of the Institute at the time of the inquiry.

For the purposes of inquiry as aforesaid, the Council and the Disciplinary Committee have the same powers as are vested in a Civil Court under the Code of Civil Procedure, 1908, in respect of the following matters:

(*a*) summoning and enforcing the attendance of any person and examining him on oath;
(*b*) the discovery and production of any document; and
(*c*) receiving evidence on affidavit.

(c) APPEALS

Under Section 22A, any member, aggrieved by any order of the Council, may prefer an appeal, to the High Court.

Under Section 22A(2), the High Court may, on its own motion or otherwise, revise any order made by the Council under Section 21(2) or (4) of the Act and may—

(*a*) confirm, modify or set aside the order;
(*b*) impose any penalty or set aside, reduce, confirm or enhance the penalty imposed by the order;
(*c*) remit the case to the Council for such further inquiry as the High Court considers proper in the circumstances of the case; or
(*d*) pass such other order as the High Court thinks fit.

The High Court, must give a hearing to the Council before modifying or setting aside its order and must give a hearing to the person concerned before enhancing a penalty.

From the order of the High Court either under Section 21 or 22A, a further appeal lies to the Supreme Court.

§ 9. Disciplinary Cases

Some of the important cases of disciplinary action under Section 21, Chartered Accountants Act, 1949, are discussed hereunder:

(A) COMMISSIONER OF INCOME-TAX, MADRAS v. G. M. DANDEKAR (1952, 22 Company Cases, 356).

Held—THAT THERE CAN BE NO NEGLIGENCE UNLESS THERE IS A DUTY CAST UPON THE PERSON TO DO A PARTICULAR ACT AND HE FAILS TO DO IT.

THE CHARTERED ACCOUNTANT IS UNDER NO DUTY TO THE INCOME-TAX DEPARTMENT TO INVESTIGATE WHETHER THE ACCOUNTS PRODUCED BY THE ASSESSEES ARE CORRECT OR NOT. THIS IS A MATTER FOR THE DECISION OF THE INCOME-TAX TRIBUNALS. THE POSITION OF CHARTERED ACCOUNTANTS REPRESENTING THE INCOME-TAX ASSESSEES IS SIMILAR TO THAT OF ADVOCATES REPRESENTING PARTIES IN COURT AND THAT THEIR OBLIGATIONS ARE SIMILAR TO THOSE OF ADVOCATES.

The respondent was entrusted with the work of auditing the accounts and preparing Income-tax returns of the assessee. The respondent examined only the regular account books of the assessees and prepared the statements and income-tax return on the basis of these accounts. All the statements were signed by him and there was also an endorsement at the foot of the balance sheet that it was "verified and found to be correct."

In the covering letter the respondent stated as under:

"The books of accounts are kept in the Gujarati style in the usual course of business and the statement and schedules prepared therefrom represent in our opinion correct income of the firm."

The Income-tax Officer, on assessment, found that the assessee maintained two sets of accounts. The Income-tax Officer held that there were discrepancies in the accounts and that they were inaccurate and unreliable. The action was brought by the Commissioner of Income-tax charging the respondent with gross negligence in the discharge of his duties. The Disciplinary Committee held that the charge of negligence was made out.

In the course of his judgment, Venkatarama Ayyar, J. said:

"We agree that the position of chartered accountants representing the income-tax assessees is similar to that of advocates representing parties in court and that their obligations are similar to those of advocates. But what are the obligations of the advocates? They are bound to act strictly within the instructions of their clients; they are under a duty not to misrepresent facts or to mislead the court and they should be no parties in any manner to setting up false defences but they are under no obligation to suspect their clients or to investigate whether their case is true or false. It is a matter for the court to decide and not for the advocates to "probe into". In like manner the accountant is under a duty to prepare and present correct statements of the accounts of the assessees; and he should, of course, neither suggest nor assist in the preparation of false accounts. But he is under no duty to investigate whether the accounts produced by the assessees are correct or not. That is a matter for the decision of the Income-tax Tribunals."

The Court held that the respondent was under no duty to the Income-tax Department to investigate the truth and correctness of the accounts of the assessee and therefore no question of negligence arose.

In this connection the provisions of Sections 278, Income Tax Act, 1961 should be noted.

(B) P. M. HEGDE, *In Re* (1954, 24, Company Cases. 453).

Held—IT IS THE DUTY OF THE AUDITOR OF A BANK, EXCEPT IN SPECIAL CIRCUMSTANCES, TO VERIFY THE CASH IN HAND ON THE MATERIAL DATE AND EVEN WHEN AT A LATER DATE HE MAKES A CHECK, IF HE DOES NOT EXAMINE THE INTERMEDIATE TRANSACTIONS, HE FAILS IN HIS DUTY TO SATISFY THAT THE ASSETS WERE THERE.

IT IS THE DUTY OF AN AUDITOR TO HAVE MENTIONED IN HIS REPORT THAT THERE WAS NON-COMPLIANCE WITH THE STATU-

TORY DIRECTION CONTAINED IN SECTION 101 (2B), INDIAN COMPANIES ACT, 1913.

In this case, a complaint was made by the Registrar of Companies, Bombay, against the respondent as the auditor of the Rural Bank of India Ltd., that he was guilty of professional misconduct.

Briefly, the facts of the case were that the cash on hand as per the balance sheet fell very much short of the actual cash on hand. The moneys received from applicants for shares were not deposited and kept in a Scheduled Bank as required by Section 101 (2B) of the Indian Companies Act, 1913. The Managing Director admitted, *inter alia,* that cash was not actually received from all the share applicants and that imaginary deposits were created in the books of Best Security Trust Ltd., (one of the shareholders) for the purchase of shares of the Bank. It was not disputed that the Bank had on several occasions debited to the accounts of certain persons loans which were bogus.

The first charge against the respondent was that even though he certified that the cash and securities had been verified by him, he did not in fact do so. The respondent stated that he verified the cash in hand on the several dates, he visited the Bank for audit, in each of the years, but those dates were later than the dates of the Balance Sheets concerned. He admitted that he had not verified the intermediate transactions between the several dates of the Balance Sheets and the dates on which he actually checked the cash.

The second charge was that the respondent failed to report to the shareholders on the non-compliance with the provisions of Section 101(2B) of the Indian Companies Act (now Section 69(4), the Companies Act, 1956). It was admitted before the Court that the company did contravene this provision. The explanation given by the Managing Director was that the Scheduled Bank was 100 miles away, and that it could be reached only by bus, and that within a week the certificate to commence business would be obtained.

The third charge was that the respondent failed to make proper enquiries regarding the financial position of Best Security Trust Ltd., with a view to satisfy himself as to its capacity for

making large investments and verifying whether the fixed deposit receipts of that company held as security by the Bank were worth their face value and were sufficient cover for the loans.

In the course of his judgment, Rajamannar, C.J., said:

"....

The duties of an auditor were set out in the same way in another leading case, viz., *In re City Equitable Fire Insurance Co. Ltd.* It is sufficient to refer to the following passage from the judgment of POLLOCK M. R. in that case:—

What is the standard of duty which is to be applied to the auditors? That is to be found, and is sufficiently stated, I think, *In re Kingston Cotton Mill Co.* (No. 2). As I have already said it is quite easy to charge a person after the event and say 'How stupid you were not to have discovered something which, if you had discovered it, would have saved us and many others from many sorrows.' But it has been well said that an auditor is not bound to be a detective or to approach his work with suspicion or with a foregone conclusion that there is something wrong. 'He is a watchdog, but not a bloodhound.' That metaphor was used by LOPES L.J., in *In re Kingston Cotton Mill Co.* (No. 2). Perhaps, casting metaphor aside, the position is more happily expressed in the phrase used by my brother SARGANT L.J. who said that the duty of an auditor is verification and not detection. *The Kingston Cotton Mill* case is important, because expansion is given to those rather epigrammatic phrases. LINDLEY L.J., says: 'It is not sufficient to say that the frauds must have been detected if the entries in the books had been put together in a way which never occurred to any one before suspicion was aroused. The question is whether, no suspicion of anything wrong being entertained, there was a want of reasonable care on the part of the auditors in relying on the returns made by a competent and trusted expert relating to matters on which information from such a person was essential.'

In our opinion, the facts disclosed in this case justify us in the holding that the respondent has not discharged the duties which lay on him as an auditor. We do not say that it was the duty of the respondent to have discovered the fraud, if any, of the managing director or the other directors of the Bank. Nor is it necessary to find that the respondent would have discovered the window-dressing transactions and devices resorted to by the directors. But we do think that there was enough appearing on the face of the accounts to provoke suspicion, and once suspicion was aroused, it was his duty to have made inquiries."

The Court held the respondent guilty of gross negligence and administered a severe warning to the respondent that in future audits he should keep in mind his duties as an auditor and that similar conduct on his part in future would entail grave and adverse consequences.

(c) DEPUTY SECRETARY TO THE GOVERNMENT OF INDIA, MINISTRY OF FINANCE v. S. N. DAS GUPTA (1955, 25 Company Cases, 413).

Held—IF AN AUDITOR DOES NOT DO WHAT IT IS HIS DUTY TO DO, IT IS NO DEFENCE FOR HIM TO SAY IN A DISCIPLINARY PROCEEDING THAT HE HAD TOLD THE SHAREHOLDERS THAT HE HAD NOT DONE IT. HIS FAILURE TO PERFORM HIS DUTY IS NOT EXCUSED BY GIVING INFORMATION OF THE OMISSION TO THE SHAREHOLDERS.

THAT IN A BANK AUDIT, CASH BALANCE MUST BE VERIFIED BY THE AUDITOR.

The respondent was the auditor of the Aryan Bank Ltd., during the years 1942, 1943 and 1944, which ultimately went into liquidation.

The facts found by the Disciplinary Committee were that:

The reports made by the respondent in respect of the years 1942 and 1943 were in the form of a certificate, merely answering the four questions specified in section 145(2) of the Indian Companies Act, in the affirmative and they were subject in each case to a special report. The charges against the respondent were:

(1) He failed to verify the cash in hand in respect of the years 1942 and 1943 and hence he failed to discharge the duty which lay on him under the law and the approved audit procedure. The fact that he had stated in the special report that he had not personally verified the cash could not absolve him from his statutory liability.

(2) As regards 1942, there occurred the following statement in the special report:

"All the loans and overdrafts of branches are shown in the balance sheet as good."

The respondent stated that he inserted the statement as he had some doubt as to some of the loans.

As regards the loans which were shown in the balance sheet as fully secured, the special report contained the following sentence:

"These have been granted to eight parties against the fixed deposit receipts of debtors."

The finding of the Disciplinary Committee was that if the respondent felt some doubt as to some of the loans, overdrafts and fixed deposits, as he said he had felt and if he found it necessary to qualify his reports by certain reservations made in the special reports, he should have expressed himself unequivocally on the suspected items instead of making cryptic statements which might mean anything or nothing. The Committee stated that his duty was to give information and not merely means of information.

(3) The Committee found that the alleged verification of cash in hand at the end of the year 1944 was falsified by the fact that the confirmation letters from other banks had been received after the respondent had already signed the report.

In the course of his judgment, Chakravarti, C.J. said:

"..... The Companies Act, therefore, provides for the employment of an auditor who is the servant of the shareholders and whose duty it is to examine the affairs of the company on their behalf at the end of a year and report to them what he has found. That examination by an independent agency such as the auditor is practically the only safeguard which the shareholders have against the enterprise being carried on in an unbusiness-like way or their money being mis-applied or misappropriated without their knowing anything about it. The Act provides the safeguard in two forms. It makes it the duty of the auditors to give an expression of opinion on certain specified matters of a vital character and it makes him liable, along with the directors, for misfeasance, if he fails to perform his duties as required by law and the approved audit procedure..... It is now well settled that it is the duty of an auditor to verify not merely the arithmetical accuracy of the balance sheet but its substantial accuracy and to see that it includes the particulars required by the articles and the statute and contains a correct representation of the state of the company's affairs..... An auditor's duty is to see what the state of the company's affairs actually is and whether it is reflected truly in the accounts of the company upon which the balance sheet and the profit and loss account are based, but he is not required to perform the functions of a detective. As has been said, he is a watch-dog but not a bloodhound and, as the same thing has been said without the aid of a metaphor, his duty is verification and not detection, although in performing the duty of verification he must employ reasonable care and skill. What is reasonable care and skill must depend on the circumstances of each case. Where there is nothing to excite suspicion and there is an atmosphere of complete confidence, based on the record of continued success in financial matters, less care and less severity of scrutiny may be considered reasonable, whereas reasonable care and skill may be regarded as not exercised when, in spite of the presence of unusual features in the accounts or other *prima facie* reasons for believing that the affairs of the company may not be in order, the examination is perfunctory and not sufficiently detailed. One aspect of the question of reasonable care and skill is whether the auditor may properly rely on the statements of a director-in-charge or the managing director, but that again must depend on the circumstances of each case and on the nature of the subject-matter which requires explanation. The information and explanations must necessarily come from the management and, except in the case of matters which are capable of direct verification, it may not be improper for an auditor to accept their statements when they are persons of accepted competence and integrity, when there is nothing unusual

in the accounts and when the subject-matter is such that were the auditors to verify the result themselves, they would have to tally a multitude of entries in several linked accounts. If in such circumstances, that is to say, when the subject-matter is one which is not capable of direct verification and when to verify properly the result presented in the balance sheet, it would require investigation rather than checking and where there is nothing at all to excite suspicion, if in relying upon the statements in such circumstances, the auditor is himself deceived, he will not be held to have failed in the discharge of his duties. ..... The audit with which we are concerned in the present case is the audit of a banking company. Such an audit has been called a balance sheet audit, meaning thereby that it is primarily confined to the verification of the existence of assets shown in the balance sheet, because on account of the multitudinous character of the transactions of a bank, it is not ordinarily possible to examine every one of them, nor is it usually done except with reference to matters, if any, which provoke enquiry..... *Vis-a-vis* the shareholders, the auditor holds a position of trust and it is his bounden duty to honour that trust by being candid with the shareholders and telling them frankly and fully everything with regard to the affairs of the company which has come to his knowledge and which it is material for the shareholders to know. It is only fair to add that there may be circumstances in which it will not be to the interest of the shareholders themselves that all the information regarding the company should be included in a public and printed document like the auditor's report.... Authorities, both legal and professional, are unanimous that in a bank audit, the cash balance claimed by the management must be verified by the auditor, because otherwise the management might remove the greater part of the funds and show them falsely as lying in hand in cash and thereby relieve themselves of the necessity of even making up accounts, showing the disposition of the money..... In spite of having felt these doubts and such uneasiness, the respondent did not inform the shareholders frankly and directly what the facts were which had caused misgivings in his mind, but he chose to employ some euphemistic or enigmatical language which might or might not be taken by the shareholders to be of any significance and which certainly conveyed no definite information.

The High Court found the respondent guilty of misconduct and made an order that he should be suspended from the membership of the Institute of Chartered Accountants and from practice for two years from the date of the order.

(D) S. GANESAN v. A. K. JOSCELYNE (1957, 27, Company Cases, 114).

Held—THAT PROFESSIONAL MISCONDUCT ON THE PART OF A PERSON EXERCISING ONE OF THE TECHNICAL PROFESSIONS CAN-

NOT FAIRLY OR REASONABLY BE FOUND, MERELY ON A FINDING OF A BARE NON-PERFORMANCE OF A DUTY OR SOME DEFAULT IN PERFORMING IT.

THE TEST MUST ALWAYS BE WHETHER IN ADDITION TO THE FAILURE TO DO THE DUTY, PARTIAL OR ENTIRE, WHICH HAD HAPPENED, THERE HAD ALSO BEEN FAILURE TO ACT HONESTLY AND REASONABLY.

In this case, a shareholder of the Deccan Sugar and Abkhari Company Ltd., addressed a complaint to the Institute of Chartered Accountants of India against the auditors of the company.

The said company in an agreement with its managing agents provided that the managing agents would receive, "by way of remuneration for their services, (*a*) an allowance of Rs. 5,000 per mensem, ... and (*b*) a commission of ten per cent on the annual profits of the company." In a separate sub-paragraph in the same agreement it was provided that the managing agents "shall also receive commission .... on account of sales of the company's products elsewhere than in Madras City, at or through their branches or agencies."

In the relevant Profit and Loss Account of the company the amount shown as paid to managing agents for the remuneration included only the sum paid to them on the monthly basis and the sum due to them as a percentage of profits. An amount of Rs. 35,400 paid as commission on sales was not shown as a part of the remuneration of managing agents. The said amount was also not shown as an item of expenditure in the Profit and Loss Account either separately or by including it in the selling expenses, The selling commission paid to the managing agents was deducted out of the gross receipts and the net amount so arrived at was shown as the gross profit.

The charges against the auditors were that:

(1) They had misled the shareholders by not reporting to them the non-disclosure of the remuneration paid to the managing agents on account of the sales of the company's products.

(2) They had also failed to report to the shareholders the mis-statement contained in the profit and loss account regarding the gross income, such mis-statement being an understate-

ment of the income resulting from a direct deduction of the sales commission from the sales in the trading account.

(3) They failed to disclose the total of the amounts paid to the managing agents as distinct item in the profit and loss account; and

(4) The auditors were in clear negligence of their duties and with a desire to accommodate the managing agents and directors to conceal the payments of commission on sales to managing agents from the knowledge of the shareholders, went to the extent of giving misleading reports that the accounts were in conformity with the law.

The fourth charge was subsequently withdrawn.

The findings of the Disciplinary Committee were as under:

"The respondent failed to report on (1) the non-compliance of section 132(3) and regulation 107 of Table A of the Indian Companies Act, and (2) the non-disclosure of the commission on sales of the company's products at or through their branches or agencies as part of the managing agents' remuneration in the profit and loss account, thereby misleading the shareholders into the belief that a lower sum was paid to the managing agents, and offending against clauses (o) and (p) of the Schedule to the Chartered Accountants Act, 1949."

In the course of his judgment, Chakravartti, C.J., said:

"The material fact appears to me to be the payment of the selling commission. It was material, because it was important for shareholders to know that was being paid to the managing agents by way of their remuneration so that they might see if the managing agency was costing too much and if the company was carrying too heavy a load. It was also material, because section 132(3) regards the disclosure of the remuneration, provided it is remuneration contemplated by the sub-section, to be material. Translated into terms of the facts of the case, the charge under item (o) would mean that the respondent failed to disclose the payment of the selling commission which was a material fact and which had not been disclosed in the profit and loss account, but disclosure of which was necessary so that the profit and loss account might not mislead the shareholders by making it appear that the managing agents had received a smaller payment than had actually been made to them. Similarly translated into the concrete facts of the case, the charge under item (p) would mean that the respondent failed to report the misstatement in the profit and loss account regarding the gross income, such misstatement being an understatement of the real gross income, caused by a prior deduction of the selling commission in the trading account which was not made known to

the shareholders. It was also a misstatement regarding the quantum of the expenses incurred, since the amount was not shown as an item of expenditure at all and had the effect of stating wrongly to the shareholders that the sales had been merely what had been shown in the profit and loss account and not the amount shown there plus the amount of the selling commission, paid out from the receipts. Even if the figures stood for gross profit, it was misleading.....

"Professional misconduct on the part of a person exercising one of the technical professions cannot fairly or reasonably be found, merely on a finding of a bare non-performance of a duty or some default in performing it. The charge is not one of inefficiency, but of misconduct and in an allegation of misconduct, an imputation of a certain mental condition is always involved. I think, it would be impossible for any professional man to exercise his profession if he was to be held guilty of misconduct simply because he had not, in a given case, been able to do all that was required in the circumstances or he had misconceived his duty or failed to perform a part of it. I think the test must always be whether in addition to the failure to do the duty, partial or entire, which had happened, there had also been a failure to act honestly and reasonably.

"Judging by that test, I am unable to hold that the respondent acted in this case with reasonable care. The difficulty, however, is that he has been charged only under items (o) and (p) of the Schedule, but has not been charged under item (q) which is concerned with "gross negligence" in the conduct of professional duties. Even apart from negligence, there might have been a ground for proceeding against the respondent if it could be established against him that he had been a willing party to or at least had connived at the concealment of the payment of the selling commission by the directors. On that point again, there is the difficulty that the complainant withdrew the allegation that the respondent had acted with a desire to accommodate the managing agency and the directors in regard to their concealing the payment of the commission."

The Court held that in view of the absence of any charge of negligence and the withdrawal of the allegation (as aforesaid) is was not possible to hold that the charges actually framed had been established, although, the Court found, that the respondent did not appear to have acted with reasonable care.

(E) R. B. BASU V. P. K. MUKHERJEE (1957, 27, Company Cases, 528).

Held—THAT ONCE IT IS PROVED THAT A CHARTERED ACCOUNTANT CHARGED FEES FOR HIS PROFESSIONAL EMPLOYMENT ON A PERCENTAGE OF PROFITS OR AS CONTINGENT ON RESULTS, HIS MISCONDUCT IS ESTABLISHED.

In this case, the respondent undertook to represent the complainant in income tax appeals before the Income Tax Appellate Tribunal and stipulated for a fee based on relief in tax which may be obtained as the result of the appeals. The allegation was that the respondent, having accepted an engagement for good consideration to appear at the hearing of the appeals, had failed to do so, and, secondly, that he had not only obtained a large sum of money by false representation, but had been trying to obtain even larger sums by means of threats. To these two charges the Disciplinary Committee added a further charge that the respondent had charged fees at a certain percentage of the expected relief.

In regard to the question of not appearing at the hearing of the appeals the Court stated that once the complainant had gone in for other representatives and had briefed counsel to appear for him in the appeals, he obviously, discharged the respondent, by his own conduct and thereafter there could be no question of the respondent being required to appear in the appeals. According to the Court the first and the second charges were not established but that the third charge was established.

In the course of his judgment, Chakravarti, C.J., said:

"There is no evidence before us of what work has been done by the respondent, but assuming he had done a large amount of work, the volume of such work does not, in my view, constitute any extenuating circumstance at all. The respondent, it ought to be remembered, is not being charged for having demanded excessive fees.

"The whole charge against him is that he charged fees on a basis which the Act forbids and which the profession disapproves. The evil which clause (m) of the Schedule aims at striking down is not the charging of exorbitant fees from persons who require the services of accountants, but the adoption of methods in charging fees, which involve a purchase by the accountant of an interest in the relief which he may secure for his client. A professional man ought to charge remuneration for the services rendered by him in a straightforward manner, commensurate with the volume and character of his exertions and must not engage in a kind of gambling. If such be the end which clause (m) of the Schedule is intended to serve, it is no answer to say that the respondent laboured long and hard in the interest of the complainant. Once it is proved that a chartered accountant charged fees for his professional employment on a percentage of profits or as contingent on results, his misconduct is established. There is no room for argument, as there may be under the Legal Practitioners Act or the Bar Councils Act each of which refers in the end to misconduct

in general terms that professional misconduct does not include engagement in champertous arrangements with clients. In the case of the Chartered Accountants Act, charging of fees on a percentage basis is specifically included among the condemned varieties of misconduct."

The Court found the respondent guilty of the misconduct of charging fees on a basis of a percentage of the profits and directed that he be suspended from practice for a period of three months.

CHAPTER XIII

AUDIT OF BANKING AND INSURANCE COMPANIES

§ 1. Banking Companies

The banking companies are governed by a special Act, the Banking Companies Act, 1949. The provisions of this Act, save as expressly provided, are in addition to those of the Companies Act, 1956, and any other law for the time being in force. The provisions of the Banking Companies Act, 1949, which are relevant for the purposes of audit are given hereunder:

(A) Restrictions on Business

A banking company cannot engage in any form of business other than the business of banking and the forms of business mentioned in Section 6(1) of the Act.

Section 8, makes an express provision prohibiting a banking company from engaging, directly or indirectly, in trading activities or undertaking any activity other than usual banking activities. It cannot hold shares in any company, whether as pledgee, mortgagee, or absolute owner, of an amount exceeding thirty per cent. of the paid-up share capital of the other company or thirty per cent. of its own paid-up share capital and reserves, *whichever is less*.

Under Section 19, restrictions are placed on the nature of business of subsidiary companies which can be formed for the purposes specified therein or for such other purposes as are incidental to the business of banking.

It cannot make loans or advances on the security of its own shares, or grant unsecured loans or advances to any of its directors or to firms or private companies in which it or any of its directors is interested as partner, or managing agent or to any individuals, firms or private companies in cases where any of the directors is a guarantor.

The Reserve Bank of India has powers to control loans and advances and to prohibit the loans and advances which are to the

detriment of the interests of the depositors of the banking company.

It cannot hold any immovable property, howsoever acquired, except such as is required for its own use for a period exceeding seven years from the date of acquisition or from the commencement of the Act, *whichever is later* unless such period is extended by the Reserve Bank of India.

(B) CAPITAL AND RESERVES

A banking company cannot carry on business in India unless it satisfies the conditions laid down in Section 12(1) which provides:

(*i*) that the subscribed capital of the company is not less than one-half of the authorised capital, and the paid-up capital is not less than one-half of the subscribed capital and that, if the capital is increased, it complies with the conditions prescribed in this clause within such period not exceeding two years as the Reserve Bank may allow:

(*ii*) that the capital of the company consists of ordinary shares only or of ordinary shares or equity shares and such preferential shares as may have been issued prior to the 1st day of July, 1944:

Provided that nothing contained in this sub-section shall apply to any banking company incorporated before the 15th day of January, 1937.

Under Section 11, a banking company cannot commence or carry on business unless the requirements, mentioned therein, as to minimum paid-up capital and reserves are complied with.

In case of a banking company incorporated outside India, a prescribed minimum amount must be kept deposited with the Reserve Bank in the prescribed manner. In addition, as soon as may be after the expiration of each calendar year, it must further similarly deposit with the Reserve Bank an amount calculated at *twenty per cent.* of its profit for that year in respect of all business transacted through its branches in India, as disclosed in the profit and loss account prepared for that year under Section 29. However, the Central Government may, on the recommendation of the Reserve Bank, and having regard to the adequacy of deposits under Section 11(2) in relation to its deposit liabilities in India, declare that this provision shall not apply to such banking company for a specified period. In the event of such a company

ceasing to carry on banking business in India, the creditors of the company will have the first charge on such deposits.

A banking company cannot create any charge upon any unpaid capital of the company which, if created, shall be invalid. A floating charge on the undertaking or any property of such company or any part thereof is invalid unless the Reserve Bank certifies in writing that creation of such charge is not detrimental to the interest of the depositors.

A banking company cannot pay directly or indirectly by way of commission, brokerage, discount or remuneration in any form in respect of any shares issued by it, any amount exceeding in the aggregate two and one-half per cent. of the paid-up value of the said shares. (Section 13).

Under Section 17(1), a banking company incorporated in India must create a reserve fund and it must, before any dividend is declared, transfer to the reserve fund a sum equal to *twenty per cent.* out of the balance of the profit of each year as disclosed in the profit and loss account. However, the Central Government may, on the recommendation of the Reserve Bank and having regard to the adequacy of the paid-up capital and reserves in relation to deposit liabilities, declare that provisions of Section 17(1) shall not apply to the banking company for a specified period. Such order can be made only if the amount of the reserve fund together with the amount of share premium is not less than the paid-up capital. Any appropriation from the reserve fund or from the share premium account, must be reported to the Reserve Bank within twenty-one days.

(c) Cash Reserves

Every *Scheduled Bank,* under Section 42, of the Reserve Bank of India Act, 1934, is required to maintain with the Reserve Bank an average daily balance, the amount of which shall not be less than *three per cent.* of the total of the *demand* and *time* liabilities in India. However, the Reserve Bank of India may, by notification in the Gazette, increase the said rates, so however that the rates shall not be more than *fifteen per cent.* of the total of the *demand* and *time* liabilities.

Similarly, the Reserve Bank of India is empowered to require a Scheduled Bank by a notification to maintain with it an addi-

tional average daily balance, so however that such balance does not exceed *fifteen per cent.* of the total of its *demand* and *time* liabilities.

Every banking company other than a Scheduled Bank must maintain in India a cash reserve equal to at least *three per cent.* of the total of its *time* and *demand* liabilities in India. Such reserves may be maintained with itself or in current account with the Reserve Bank or the State Bank of India or any other bank notified by the Central Government in this behalf or partly in cash with itself and partly in such accounts.

Under Section 24, every banking company is required to maintain *in India* in cash, gold or unencumbered approved securities, valued at a price not exceeding the current market price, an amount, which shall not at the close of business on any day be less than *twenty per cent.* of the total of its time and demand liabilities *in India.* After the expiry of two years from the commencement of the Banking Companies (Amendment) Act, 1962, such amount shall not be less than *twenty-five per cent.* of the total of time and demand liabilities in India. The said liquid assets should be kept in case of a scheduled bank in addition to the average daily balance required to be maintained under Section 42 of the Reserve Bank of India Act, 1934, and in case of other banking companies in addition to the cash reserve required to be maintained under Section 18.

Further the assets *in India* of every banking company should not be less than *seventy-five per cent.* of its demand and time liabilities *in India,* at the close of business on the last Friday of every quarter or the preceding working day if Friday is a public holiday.

(D) DIVIDENDS

Section 15 provides that:

(1) No banking company shall pay any dividend on its shares until all its capitalised expenses (including preliminary expenses, organisation expenses, share-selling commission, brokerage, amounts of losses incurred and any other item of expenditure not represented by tangible assets) have been completely written off.

(2) Notwithstanding anything to the contrary contained in sub-section (1) or in the Companies Act, 1956, a banking company may pay dividends on its shares without writing off—

(*i*) The depreciation, if any, in the value of its investments in approved securities in any case where such depreciation has not actually been capitalised or otherwise accounted for as a loss;

(*ii*) The depreciation, if any, in the value of its investments in shares, debentures or bonds (other than approved securities) in any case where adequate provision for such depreciation has been made to the satisfaction of the auditor of the banking company;

(*iii*) The bad debts, if any, in any case where adequate provision for such debts has been made to the satisfaction of the auditor of the banking company.

Before any dividend is declared, a banking company incorporated in India should comply with the provisions of Section 17. in regard to transfer of profit to reserve fund.

(E) MANAGING AGENTS, MANAGING DIRECTOR, ETC.

A banking company is not permitted to employ or be managed by a managing agent. It cannot pay to its employee remuneration or a part of remuneration which takes the form of commission or of a share in the profits of the company except bonus and it cannot pay remuneration, which in the opinion of the Reserve Bank, is excessive.

Under Section 35B, appointment or reappointment of a managing director or whole-time director, manager or chief executive officer, by whatever name called, must be made with the previous approval of the Reserve Bank. An amendment of any provision relating to the apointment or reappointment or remuneration of a managing director or any other director, whole-time or otherwise or of a manager or a chief executive officer, by whatever name called, will not have effect unless approved by the Reserve Bank. For this purpose, remuneration includes any benefit, amenity or perquisite.

(F) ANNUAL ACCOUNTS

Under Section 29, a banking company incorporated in India, in respect of all business transacted by it, is required to prepare at the expiration of each calendar year a balance sheet and profit and loss account as on the last working day of the year. A banking company incorporated outside India, in respect of business in India, must also comply with the same requirements; however, the profit and loss account may be prepared as on a date not

earlier than two months, before the last working day of the year.

(G) FORM OF ACCOUNTS

The balance sheet and profit and loss account should be prepared in the forms set out in the Third Schedule or as near thereto as circumstances admit. Section 211, Companies Act, 1956, provides that the balance sheet and the profit and loss account shall not be treated as not disclosing a true and fair view of the state of affairs of the company, merely by reason of the fact that they do not disclose—in the case of a banking company, any matters which are not required to be disclosed by the Banking Companies Act, 1949.

Whereas Section 29(3) provides that:

Notwithstanding that the balance sheet of a banking company is under sub-section (1) required to be prepared in a form other than the form set out in Part I of Schedule VI to the Companies Act, 1956, the requirements of that Act relating to the balance sheet and profit and loss account of a company shall, in so far as they are not inconsistent with this Act, apply to the balance sheet or profit and loss account, as the case may be, of a banking company.

The form of balance sheet as prescribed under Form A of the Third Schedule is as follows:

THE THIRD SCHEDULE

(*See* Section 29)

FORM A

FORM OF BALANCE-SHEET

CAPITAL AND LIABILITIES	Rs. nP.	Rs. nP	PROPERTY AND ASSETS	Rs. nP.	Rs. nP.
1. CAPITAL (*a*)—			1. CASH:		
Authorized Capital .... Shares of Rs. ..... each.....		————	In hand and with Reserve Bank and Imperial Bank (including foreign currency notes)		
Issued Capital ..... shares of Rs. ..... each		————	2. BALANCES WITH OTHER BANKS (showing whether on deposit or current account):		
Subscribed Capital.....Shares of Rs..... each ..		————	(*i*) in India		
			(*ii*) outside India	————	
Amount called up at Rs..... per share			3. MONEY AT CALL AND SHORT NOTICE		
Less: calls unpaid		————		————	
Add: forfeited shares		————			

FORM A—*contd.*

CAPITAL AND LIABILITIES	Rs. nP.	Rs. nP.	PROPERTY AND ASSETS	Rs. nP.	Rs. nP.
2. RESERVE FUND AND OTHER RESERVES.					
3. DEPOSITS AND OTHER ACCOUNTS: Fixed deposits ..... Savings Bank Deposits..... Current Accounts, Contingency Accounts, etc.			4. INVESTMENTS (stating mode of valution, *e.g.*, cost or market value): (*f*)		
4. BORROWINGS FROM OTHER BANKING COMPANIES, AGENTS, ETC.: (*i*) in India (*ii*) outside India.			(*i*) Securities of the Central and State Governments and other Trustee securities, including Treasury Bills of the Central and State Governments. (*ii*) Shares (classifying into preference, ordinary, deferred and other classes of shares and showing separately shares fully paid-up and partly paid-up). (*iii*) Debentures or bonds.		

PARTICULARS:

(*i*) Secured (stating the nature of security).

(*ii*) Unsecured

5. BILLS PAYABLE

6. BILLS FOR COLLECTION BEING BILL RECEIVABLE AS *per contra*

(*i*) payable in India

(*ii*) payable outside India

(*iv*) Other investments to be classified under proper heads

(*v*) Gold . . . . . .

5. ADVANCES (other than bad and doubtful debts for which provision has been made to the satisfaction of the auditors).

(I) Loans, Cash Credits, Overdrafts, etc.:

(*i*) In India . . . .

(*ii*) outside India . . . .

(II) Bills discounted and purchased (excluding Treasury Bills of the Central and State Governments):

(*i*) payable in India . .

(*ii*) payable outside India. . .

FORM A—*contd.*

CAPITAL AND LIABILITIES	Rs. nP.	Rs. nP.	PROPERTY AND ASSETS	Rs. nP.	Rs. nP.
7. OTHER LIABILITIES (*c*)			Particulars of Advances:		
			(*i*) Debts considered good in respect of which the banking company is fully secured		
8. ACCEPTANCES, ENDORSEMENTS AND OTHER OBLIGATIONS *per contra*:			(*ii*) Debts considered good for which the banking company holds no other security than the debtors' personal security		
			(*iii*) Debts considered good, secured by the personal liabilities of one or more parties in addition to the personal security of the debtors.		
			(*iv*) Debts considered doubtful or bad, not provided for		
9. PROFIT AND LOSS:					
Profit as per last balance sheet			(*v*) Debts due by directors or officers of the banking company or any of them either severally or jointly with any other persons ..		
Less: appropriations					
Add: profit for the year brought from the Profit and Loss Account					

10. CONTINGENT LIABILITIES (*d*) . .	(*vi*)	Debts due by companies or firms in which the directors of the banking company are interested as directors, partners or managing agents or, in the case of private companies, as members . . . .
	(*vii*)	Maximum total amount of advances including temporary advances made at any time during the year to directors or managers or officers of the banking company or any of them either severally or jointly with any other persons (*ff*) . . . .
	(*viii*)	Maximum total amount of advances, including temporary advances granted during the year to the companies or firms in which the directors of the banking company are interested as directors, partners or managing agents

FORM A—*contd.*

CAPITAL AND LIABILITIES	Rs. nP.	Rs. nP.	PROPERTY AND ASSETS	Rs. nP.	Rs. nP.
			or, in the case of private companies, as members (*ff*)		
			(*ix*) Due from banking companies		
			6. BILLS RECEIVABLE BEING BILLS FOR COLLECTION AS *per contra*		
			(*i*) payable in India ..		
			(*ii*) payable outside India ..		
			7. CONSTITUENTS' LIABILITIES FOR ACCEPTANCES, ENDORSEMENTS AND OTHER OBLIGATIONS *per contra*		
			8. PREMISES LESS DEPRECIATION (*g*)		
			9. FURNITURE AND FIXTURE LESS DEPRECIATION (*g*)		
			10. OTHER ASSETS, INCLUDING SILVER (TO BE SPECIFIED) (*h*) ..		
			11. NON-BANKING ASSETS ACQUIRED IN SATISFACTION OF CLAIMS (stating mode of valuation) (*i*)		
			12 PROFIT AND LOSS . ..		
TOTAL ..			TOTAL ..		

NOTES

(*a*) *Capital*—

(*i*) The various classes of capital, if any, should be distinguished.

(*ii*) Shares issued as fully paid-up pursuant to any contract without payments being received in cash should be stated separately.

(*iii*) Where circumstances permit, issued and subscribed capital and amount called up may be shown as one item, *e.g.* issued and subscribed capital.....Shares of Rs.....paid-up.

(*iv*) In the case of banking companies incorporated outside India the amount of deposit kept with the Reserve Bank of India under sub-section (2) of section 11 of the Banking Companies Act, 1949, should be shown under this head; the amount, however, should not be extended to the outer column.

* * * *

(*c*) Under this heading may be included such items as the following:—

Pension or insurance funds, unclaimed dividends, advance payments and unexpired discounts, liabilities to subsidiary companies and any other liabilities.

(*d*) These should be classified under the following categories:—

(*i*) Claims against the banking company not acknowledged as debts.

(*ii*) Money for which the banking company is contingently liable showing separately the amount of any guarantee given by the banking company on behalf of directors or officers.

(*iii*) Arrears of cumulative preference dividends.

(*iv*) Liability on Bills of Exchange re-discounted.

(*v*) Liability on account of outstanding Forward Exchange Contracts.

* * * *

(*f*) Where the value of the investments shown in the outer column of the balance-sheet is higher than the market value, the market value shall be shown separately in brackets.

(*ff*) Maximum total outstanding balance in all such accounts as a unit on any day during the year should be given under this heading.

(*g*) Premises wholly or partly occupied by the banking company for the purposes of business should be shown against "Premises less depreciation". In the case of fixed capital expenditure, the original cost, and additions thereto and deductions therefrom during the year should be stated, as also the total depreciation written off. Where sums have been written off on a reduction of capital or revaluation of assets, every balance-sheet after the first balance sheet subsequent to the reduction or revaluation should show the reduced figures with the date and amount of the reduction made. Furniture, fixtures and other assets which have been completely written off need not be shown in the balance-sheet.

(*h*) Under this heading may be included such items as the following, which must be shown under headings suitably described: preliminary, formation and organisation expenses, development expenditure, commission and brokerage on shares, interest accrued on investments but not collected, investments in shares of subsidiary companies and any other assets.

(*i*) Value shown shall not exceed the market value and in cases where the market value is not ascertainable, the estimated realisable value.

The Form B of the Third Schedule, which prescribes, the form of profit and loss account is as under:

FORM B

FORM OF PROFIT AND LOSS ACCOUNT

Profit and loss account for the year ended *December*

EXPENDITURE	Rs. nP.	* INCOME (LESS PROVISION MADE DURING THE YEAR FOR BAD AND DOUBTFUL DEBTS AND OTHER USUAL OR NECESSARY PROVISIONS)	Rs. nP.
1. Interest paid on deposits, borrowings, etc.		1. Interest and discount.	
2. Salaries and allowances and Provident Fund (showing separately salaries and allowances to managing director, manager or chief executive officer)		2. Commission, exchange and brokerage	
3. Directors' and Local Committee Members, fees and allowances.		3. Rents	

FORM B—*contd.*

4. Rent, taxes, insurance, lighting, etc.	4. Net profit on sale of investments, gold and silver, land, premises and other assets (not credited to Reserves or any particular Fund or Account)
5. Law Charges	
6. Postage, telegrams and stamps	
7. Auditors' fees	5. Net Profit on revaluation of investments, gold and silver, land, premises and other assets (not credited to Reserves or any particular Fund or Account) .....
8. Depreciation on and repairs to the banking company's property	
9. Stationery, printing, advertisement, etc.	
10. Loss from sale of or dealing with non-banking assets.	6 Income from non-banking assets and profit from sale of or dealing with such assets
11. Other expenditure	7. Other receipts
12. Balance of Profit	8 Loss (if any) .. ..
TOTAL ..	TOTAL ..

* Net loss on sale or revaluation of investments, gold and silver, land, premises and other asset, if any, may be deducted from income.

(II) AUTHENTICATION OF ANNUAL ACCOUNTS, ETC.

The balance sheet and profit and loss account in case of a banking company incorporated in India must be signed by the manager or the principal officer of the company and where there are more than three directors of the company, by at least three of those directors, or where there are not more than three directors, by all the directors, and in case of a banking company incorporated outside India by the manager or agent of the principal office of the company in India. [Section 29(2)]

The balance sheet and profit and loss account together with the auditor's report must be published, within a period of six months from the end of the period to which they relate, in a newspaper which is in circulation at the place where the banking company has its principal office. Copies of the annual accounts should be furnished to the Reserve Bank and should be sent to the Registrar of Companies within three months from the end of the period to which they refer.

A banking company incorporated outside India is required to display a copy of its last audited balance sheet and profit and loss account, prepared under Section 29, and also copy of its complete audited balance sheet and profit and loss account.

(I) AUDIT

Section 30 provides:

(1) The balance sheet and profit and loss account prepared in accordance with Section 29 shall be audited—
  (*a*) In the case of a banking incorporated in India, by a person duly qualified under any law for the time being in force to be an auditor of companies;
  (*b*) In the case of a banking company incorporated outside India, either by such an auditor as aforesaid, or by a person duly qualified to be an auditor under the law of the country in which the company is incorporated.

(2) The auditor shall have the powers of, exercise the functions vested in, and discharge the duties and be subject to the liabilities and penalties imposed on, auditors of companies by Section 227 of the Companies Act, 1956.

(J) AUDITOR'S CERTIFICATE

In addition to the matters which the auditor is required to state

in his report under Section 227, Companies Act, 1956, he must in case of a banking company incorporated in India state in his report:—

(*a*) Whether or not the information and explanations required by him have been found to be satisfactory;
(*b*) Whether or not the transactions of the company which have come to his notice have been within the powers of the company;
(*c*) Whether or not the returns received from branch offices of the company have been found adequate for the purposes of his audit;
(*d*) Whether the profit and loss account shows a true balance of profit and loss for the period covered by such account;
(*e*) Any other matter which he considers should be brought to the notice of the shareholders of the company.

(K) Powers and Liabilities of the Auditor

The auditor shall have the powers of, exercise the functions vested in, and discharge the duties and be subject to the liabilities and penalties imposed on, auditors of companies by Section 227 of the Companies Act, 1956.

Under Section 46, if an auditor in any return, balance sheet or other document, wilfully makes a statement which is false in any material particular, knowing it to be false, or wilfully omits to make a material statement, he is punishable with imprisonment for a term which may extend to three years and is also liable to fine. Under Section 46A he is deemed to be a public servant for the purposes of Chapter IX of the Indian Penal Code.

In the winding up proceedings, under Section 45G, an auditor of a banking company may be publicly examined. Where on such examination, the High Court is of opinion (whether a fraud has been committed or not) that a person, who has been an auditor of the banking company or a partner of a firm acting as such auditor, is not fit to act as an auditor of a company or to be a partner of a firm acting as such auditor, the High Court may make an order that, that person shall not act as an auditor of, or be a partner of a firm acting as auditors of, *any company* for such period not exceeding five years as may be specified in the order. Where

an application for sanctioning of a compromise or arrangement in respect of a banking company is made, the auditor of a banking company may be publicly examined, if so directed by the Court.

(L) AUDITOR'S DUTY

In the case of a banking company it is not possible for the auditor to examine the whole of the transactions in detail and hence it is necessary for him to examine whether the system of internal check and control is adequate. He should decide upon the scope of his examination having regard to the nature and extent of the internal check in force.

The following is a summary of the more important points in such a system:

1. The ledger clerks or machine operators should be changed about from time to time without previous notice.
2. The cashiers should not have access to the customers' ledgers.
3. The ledger clerks should have no access to the Cash Book or the Clearing House Journal.
4. The Cash Book should from time to time be compared with the actual records by independent and responsible officials, and subsequently with the ledgers.
5. No ledger keeper should be a party to testing his own work.
6. The periodical balancing of customers' accounts with the General Ledger should be performed by independent officers selected by the accountant.
7. At intervals the testing of the ledgers should include the "sides" of the accounts in addition to the extended balances, thus affording a comparative check with the Total Summation Book, to which the aggregates of payments and cheques are posted day by day.
8. The branches should be subject to frequent audits without notice by travelling auditors or inspectors.
9. An occasional audit by the bank's inspector should be in force in respect of the head office in the same manner as the branches.
10. Cashiers should not participate in the preparation or checking of bank statements, which should be checked by the

bank's officials independently of the auditors.

11. The daily incomings and outgoings of bills should be independently and systematically scrutinised by a responsible officer.
12. In respect of securities deposited against loans, advances, overdrafts, etc., there should be an effective check and supervision and the same should be periodically verified by a responsible officer. Usually there is a system of dual control, under which, the securities are kept in a safe which can be opened only with two keys—each key being separately in charge of a responsible officer.

The auditor should attend at the close of business on the day of the balance sheet, and count and weigh the cash in hand. Certificates should be obtained for the cash at the Reserve Bank of India and other banks. The cash articles should be verified; these are cheques etc., received too late on the last day of the accounts to be cleared, and can be vouched by seeing that they come through in due course within the next few days.

Money at call and at short notice is usually represented by advances to banks from day to day, and to stockbrokers on the deposit of securities from account to account. The securities lodged by the stockbrokers should be checked with the schedules appended to the borrowing notes.

The investments of the bank must be examined, special precautions being taken to prevent the same securities being produced twice. The banks usually hold securities on three accounts, viz., (1) on own account (2) as security against loans and advances and (3) for safe custody. All these securities must be produced simultaneously. The schedule of investments should show the book value and the market price on the day of the balance sheet, and it should be seen that sufficient provision is made if the total book value is in excess of the market value.

Bills in hand should be examined, and it should be seen that proper provision is made for rebate, representing the proportion of discount not earned at the date of the balance sheet.

The securities deposited against loans and overdrafts should be examined. In case of loans and advances given against pledge or hypothecation of goods, the auditor should examine the docu-

ments and satisfy himself as to the title and check the stock sheets. It should be seen that the charge is registered, where necessary, with the Registrar of Companies.

The ledger balances on current, deposit, and loan accounts should be checked, and it should be seen that sufficient provision has been made for bad debts.

The auditor should test check the vouchers for receipts and payments. The income from investments, interest income, etc., should be fully taken credit for. The interest on overdue or bad accounts, should be credited to interest suspense account and not accounted for as an income. The interest payable should be fully brought into account.

The auditor should carry out random test of a few of the bank pass-books and tally them with the ledger accounts.

The general ledger, which contains a summary of all the transactions, should be carefully scrutinised and checked with the trial balance.

The branch adjustments, which require special attention, should be checked with reference to the branch reconciliations. The inter-branch accounts should either agree or reconcile and the reconciliations should be thoroughly scrutinised to see that there are no old outstanding items and that the items have been subsequently cleared.

The auditor must give special attention to the verification of the existence, value, title and possession of the assets.

The auditor should verify the liabilities on account of letters of credit and guarantees given by the bank on behalf of its constituents, with reference to the documents and registers and it should be seen that adequate margin is held. In respect of drafts issued and T.T. payable the liabilities should be verified with reference to the documentary evidence.

He should see that all liabilities have been brought into account and in respect of contingent liabilities an adequate note is placed at the foot of the balance sheet.

He should see that loans and advances are properly classified into secured and unsecured and, that the information required by Form A is fully set out in the balance sheet.

He must satisfy himself that the transactions of the banking company which have come to his notice have been within the

powers of the company.

The banking companies usually possess secret reserves. The Form of Profit and Loss Account requires that "income" should be shown after deducting provision made during the year for bad and doubtful debts and other usual or necessary provisions. The provision for bad and doubtful debts should have been made to the satisfaction of the auditors. The secret reserves are usually created by a credit to the contingency account and by understatement of income, etc. The secret reserves are justified on the ground that the bank may have to absorb unforeseen losses on account of bad debts, loss on sale of investments, exchange losses and losses due to fraud and defalcation.

The special provisions of the Banking Companies Act, 1949, which affect the accounts and audit of the banking companies should be duly complied with.

The auditor should see that the provisions of Section 228, Companies Act, 1956, in respect of audit of the branches, have been duly complied with.

§ 2. Life Insurance Corporation

The Life Insurance Corporation Act, 1956, provides for the nationalisation of life insurance business in India by transferring all such business to a Corporation established for the purpose. It provides for the regulation and control of the business of the Corporation and for matters connected therewith or incidental thereto.

With effect from 1st September 1956, the Central Government has established a Corporation called "The Life Insurance Corporation of India" which is a body corporate having perpetual succession and a common seal. The original capital of the Corporation is fixed at five crores of rupees which is provided by the Central Government. Except to the extent otherwise expressly provided in the Act, under Section 30 of the Act, the Corporation has the exclusive privilege of carrying on life insurance business in India.

Under Section 25, the accounts of the Corporation are required to be audited by auditors duly qualified to act as auditors of companies. The auditors are appointed by the Corporation with the previous approval of the Central Government and the remuneration is fixed by the Central Government. Such auditors, in the

performance of the duties, shall have at all reasonable times access to the books, accounts and other documents of the Corporation. The auditors are required to submit the report to the Corporation and also are required to forward a copy thereof to the Central Government. The Central Government, *inter alia,* should cause the report of the auditors, under Section 25, to be laid before both Houses of Parliament as soon as may be after such report is received by the Central Government.

Sections 24, 26, 27 and 28 deal respectively with, funds of the Corporation; actuarial valuations; annual report of activities of Corporation and utilisation of surplus. Section 43 of the said Act, specifies the sections of The Insurance Act, 1938, which apply to the Corporation.

In view of the nationalisation of life insurance business, the provisions applicable to life insurance business and the audit thereof, being of limited interest, are not dealt with in detail.

§ 3. General Insurance Business

The relevant provisions of The Insurance Act, 1938, relating to general insurance business are discussed hereunder.

Under Section 2, Clause (6B), "general insurance business" means fire, marine or miscellaneous insurance business, whether carried on singly or in combination with one or more of them.

Section 2, Clauses (6A), (13A) and (13B), respectively define "fire insurance business", "marine insurance business" and "miscellaneous insurance business."

(A) *Registration.*

Section 3 provides that no person shall begin to carry on any class of insurance business in India unless he has obtained from the Controller a certificate of registration for the particular class of insurance business in the manner provided. Under the circumstances specified in Section 3(4), the Controller has the power to cancel the registration of an insurer either wholly or in so far as it relates to a particular class of insurance business as the case may be. An insurer who has been granted a certificate of registration under Section 3 should have the registration renewed annually for each year on payment of the prescribed fee.

(B) *Deposits.*

Under Section 7, every insurer, not being an insurer specified in sub-clause (c) of clause 9 of Section 2 shall, in respect of the insurance business carried on by him in India deposit and keep deposited with the Reserve Bank of India for and on behalf of the Central Government the prescribed amount either in cash or in approved securities estimated at the market value of the securities on the day of deposit, or partly in cash and partly in approved securities so estimated. The amount to be so deposited is prescribed as under:

(*a*) For Fire Insurance business only	Rs. 1,50,000
(*b*) For Marine Insurance business only ..	Rs. 1,50,000
(*c*) For Miscellaneous Insurance business only ..	Rs. 1,50,000
(*d*) For Fire, Marine and Miscellaneous Insurance business combined	Rs. 3,50,000
(*e*) For any two of (i) Fire, (ii) Marine and (iii) Miscellaneous Insurance business ..	Rs. 2,50,000
(*f*) Where the business is that of marine insurance only and relates exclusively to country craft or its cargo or both	Rs. 10,000

Section 120 provides that the market value on the day of deposit of securities, deposited in pursuance of any of the provisions of this Act with the Reserve Bank of India shall be determined by the Reserve Bank of India whose decision shall be final.

Sections 8 and 9 respectively deal with reservation of deposits and refund of deposits.

(C) *Assets of Insurer.*

Section 31 provides that none of the assets of any insurer shall, except in the case of deposits made with the Reserve Bank of India under Section 7 or Section 98 or in so far as assets are required to be vested in trustees by sub-section 6 of Section 27, be kept otherwise than in the name of a public officer approved by the Central Government, or in the corporate name of the undertaking, if a company, or in the name of the partners, if a firm, or in the name of the proprietor, if an individual. This provision shall

not be deemed to prohibit the endorsement in favour of a banking company of any security or other document solely for the purpose of collection or for realisation of interest, bonus or dividend.

(D) *Provisions relating to managers, etc.*

The business of an insurer cannot be managed by a company or a firm nor be directed or managed by a person employed as manager or officer or in any capacity, whose remuneration or part thereof takes the form of commission or bonus in respect of the general insurance business of the insurer. However, this provision is not deemed to prohibit payments mentioned in first proviso of Section 31A. The Central Government has power to restrict payments of excessive remuneration. An insurer cannot appoint a managing agent for the conduct of his business.

(E) *Agents.*

Section 42 provides that the Controller or an officer authorised by him in this behalf shall, in the prescribed manner and on payment of the prescribed fee, issue to any person making an application in the prescribed manner a licence to act as an insurance agent for the purpose of soliciting or procuring insurance business. Such licence entitles the holder to act as an insurance agent for an insurer.

Section 43 requires an insurer to maintain a register showing the name and address of every insurance agent appointed by him and the date on which his appointment began and the date, if any, on which his appointment ceased.

(F) *Register of Policies.*

Section 14 requires that a register or record of policies should be kept in which shall be entered, in respect of every policy issued by the insurer, the name and address of the policy holder, the date when the policy was effected and a record of any transfer, assignment or nomination of which the insurer has notice.

(G) *Register of Claims.*

Section 14 also requires that a register or record of claims should be maintained in which shall be entered every claim made

together with the date on which the claim was made, the name and address of the claimant and the date on which the claim was discharged, or in the case of a claim which is rejected, the date of rejection and the grounds therefor.

(H) *Commission and Rebates.*

Section 40A provides that no person shall pay or contract to pay to an insurance agent and no insurance agent shall receive or contract to receive, by way of commission or remuneration in any form, in respect of any policy of general insurance effected through an insurance agent, an amount exceeding:—

(*i*) Where the policy relates to fire or miscellaneous insurance, *fifteen per cent.* of the premium payable on the policy, and
(*ii*) Where the policy relates to marine insurance, *ten per cent.* of the premium payable on the policy.

Section 41 prohibits any rebate of the whole or part of the commission or of the premium. The prohibition applies to a person paying such rebate as well as to a person receiving such rebate.

(I) *Prohibition of Loans.*

Under Section 29, an insurer cannot, except in the circumstances mentioned therein, grant loans or temporary advances either on hypothecation of property or on personal security or otherwise, to any director, manager, actuary, auditor or officer of the insurer if a company, or where the insurer is a firm, to any partner therein, or to any other company or firm in which any such director, manager, actuary, officer or partner holds the position of a director, manager, managing agent, actuary, officer or partner.

(J) *Limitation of Expenses of Management.*

Section 40C provides as under:

(1) After the 31st day of December, 1949, no insurer shall, in respect of any class of general insurance business transacted by him in India, spend in any calendar year as expenses of management including commission or remuneration for procuring business an amount in excess of the prescribed limits and in prescribing any such limits regard shall be had to the size and age of the insurer:

Provided that where an insurer has spent as such expenses in any year an amount in excess of the amount permissible under this sub-section, he shall not be deemed to have contravened the provisions of this section, if the excess amount so spent is within such limits as may be fixed in respect of the year by the Controller after consultation with the Executive Committee of the General Insurance Council constituted under section 64F, by which the actual expenses incurred may exceed the expenses permissible under this sub-section.

(2) Every insurer as aforesaid shall incorporate in the revenue account a certificate signed by the chairman and two directors and by the principal officer of the insurer, and by an auditor certifying that all expenses of management wherever incurred, whether directly or indirectly, in respect of the business referred to in this section, have been fully debited in the revenue account as expenses.

Explanation.—In this section,—

(*a*) "calendar year" shall have the meaning assigned to it in section 40B;

(*b*) "expenses of management" means all charges, wherever incurred whether directly or indirectly, including commission payments of all kinds and, in the case of an insurer having his principal place of business outside India, a proper share of head office expenses, which shall not be less than such percentage as may be prescribed, of his gross premium income (that is to say, the premium income without taking into account premiums on reinsurance ceded or accepted) written direct in India during the year;

(*c*) "insurance business transacted in India" includes insurance business, wherever effected, relating to any property situate in India or to any vessel or aircraft registered in India.

Rules 17-E and 17-F of the Insurance Rules, 1939, are as under:—

17E. *Limitation of expenses of management in general insurance business*—(1) After the 31st day of December 1949, no insurer shall, in respect of general insurance business transacted by him in India other than marine insurance business, spend in any calendar year as expenses of management, including commission or remuneration for procuring business an amount exceeding the sum of—

(*i*) the amount of commission or other remuneration paid to insurance agents and principal agents in respect of that business transacted in the year but not exceeding 15 per cent. of the gross premium income written direct in India in respect of that business in the year; and

(*ii*) an amount computed on the bases of the percentages appro-

priate to the various parts of total gross premium income written direct in India during the year:

Part of the total gross premium income of the insurer written direct in India (Fire and Miscellaneous business combined)	Percentage of premiums
First 10 lakhs of rupees	35
Next 5 lakhs of rupees	32½
Next 5 lakhs of rupees	30
Next 7½ lakhs of rupees	27½
Next 7½ lakhs of rupees	25
Next 10 lakhs of rupees	22½
The balance	20

(2) After the 31st day of December 1949, no insurer shall, in respect of marine insurance business transacted by him in India, spend in any calendar year as expenses of management, including commission or remuneration for procuring business an amount exceeding the sum of:—

(*i*) the amount of commission or other remuneration paid to insurance agents and principal agents in respect of that business transacted in the year but not exceeding in amount ten per cent. of the gross premium income written direct in India in respect of that business in the year; and

(*ii*) an amount computed on the basis of percentages appropriate to the various parts of his total gross premium income written direct in India during the year:

Part of the total gross premium income of the insurer written direct in India	Percentage of premiums
First 5 lakhs of rupees	25
Next 5 lakhs of rupees	22½
Next 5 lakhs of rupees	20
Next 7½ lakhs of rupees	17½
The balance	15

(3) Notwithstanding anything contained in sub-rules (1) and (2), an insurer may during the first ten years of his general insurance business, spend in any calendar year as expenses of management including commission or remuneration for procuring business an additional amount, in respect of his general insurance business, not exceeding—

(*i*) during the first three years, the interest earned on the paid-up capital in that year;

(*ii*) during the second period of three years, an amount equal to 10 per cent. of the gross premium income written direct in India or to the interest earned on the paid-up capital in that year, whichever is less;

(*iii*) during the seventh and eighth years an amount equal to 5 per cent. of the gross premium income written direct in India, or to three-fourths of the interest earned on the paid-up capital in that year whichever is less:

Provided that nothing in this clause shall apply to regulate the expenses of an insurer in any such year if his gross premium income in that year exceeds twenty-five lakhs of rupees;

(*iv*) during the nineth and tenth years an amount equal to 3 per cent. of the gross premium income written direct in India, or to half of the interest earned on the paid up capital in that year whichever is less:

Provided that nothing in this clause shall apply to regulate the expenses of an insurer in any such year if his gross premium income in that year exceeds twenty-five lakhs of rupees.

Explanation—For the purposes of this rule, where two or more insurers carry on general insurance business, to one of whom the other or each of the others stands in the relation of a subsidiary company within the meaning of the Indian Companies Act, 1913, the percentages specified in this rule shall be deemed to be the percentages of the aggregate premiums of the two insurers or all the insurers as the case may be and the insurers together shall not spend as expenses of management anything in excess of the limits specified herein.

17F. *Head Office expenses*—The share of the Head Office expenses in the case of an insurer having his principal place of business outside India for the purposes of sections 40B and 40C of the Act shall not be less than—

(*i*) in respect of life insurance business 10 per cent. of the first year's premium as shown in the revenue account, and 1 per cent. of the renewal premiums as shown in the revenue account in respect of that business transacted in India during the year; and

(*ii*) in respect of general insurance business 5 per cent. of the gross premium income written direct in India during the year in respect of that business.

Under Section 44A, the Controller may for the purposes of ensuring compliance with Section 40C, require from an insurer such information certified if so required by an auditor or actuary, as he may consider necessary.

(K) *Separation of accounts and funds.*

Under Section 10, an insurer carrying on business of more than one class, is required to keep a separate account of all receipts and payments in respect of each such class of insurance business. Where the insurer carries on miscellaneous insurance business either alone or in conjunction with business of another class, he should keep a separate account of all receipts and payments in respect of each such sub-class of business as may be prescribed in this behalf, unless the Controller waives this requirement in writing.

(L) *Accounts and balance sheet.*

Section 11(1) provides as under:—

Every insurer, in the case of an insurer specified in sub-clause (*a*)(*ii*) or sub-clause (b) of clause (9) of section 2 in respect of all insurance business transacted by him, and in the case of any other insurer in respect of the insurance business transacted by him in India, shall at the expiration of each calendar year prepare with reference to that year—

(*a*) in accordance with the regulations contained in Part I of the First Schedule, a balance-sheet in the form set forth in Part II of that Schedule;

(*b*) in accordance with the regulations contained in Part I of the Second Schedule, a profit and loss account in the forms set forth in Part II of that Schedule, except where the insurer carries on business of one class only of the classes specified in clauses (*a*), (*b*) and (*c*) of sub-section (1) of section 7 and no other business;

(*c*) in respect of each class or sub-class of insurance business for which he is required under sub-section (1) of section 10 to keep a separate account of receipts and payments a revenue account in accorddance with the regulations, and in the form or forms, set forth in the Third Schedule applicable to that class or sub-class of insurance business.

THE FIRST SCHEDULE

(*See* section 11.)

REGULATIONS AND FORMS FOR THE PREPARATION OF BALANCE-SHEET

PART I.—REGULATIONS

1. The balance-sheet required to be prepared in respect of every class of business carried on by an insurer is, in the form in which it is set out in Part II of this Schedule (Form A), appropriate to a case where the insurer maintains a separate fund in respect of life insurance business.

2. The balance-sheet of life insurance business shall be prepared as a separate document. The balance-sheet of any class of business may be prepared as a separate document instead of being incorporated by the addition of columns and headings in the general balance-sheet, but the totals of each such separate balance-sheet (showing the total assets of the class of business, the balance at the credit of the life insurance fund or other separate fund or account, the amount of share-holders' undivided profits, and outstanding liabilities) must in any case be incorporated in the general balance-sheet.

3. If any combined balance-sheet is for any purpose issued by an insurer, it should be in accordance with the Form set out in this Schedule, and there shall not be included among the assets shown in any such combined balance-sheet any amount in respect of any holding in or advance to any insurer whose assets and liabilities have been incorporated therein. Every combined balance-sheet must show clearly on the face thereof that it is a combine balance-sheet and must set out fully the name of every insurer whose assets and liabilities have been incorporated therein; if the assets and liabilities of any person not being an insurer are included in a combined balance-sheet the fact must be stated thereon.

4. Where any guarantee has been given by an insurer (otherwise than in the ordinary course of re-insurance business) in respect of the policies of any other insurer, the balance-sheet of the insurer by whom the guarantee was given must show clearly the name of every insurer whose policies have been so guaranteed and the extent of the guarantee:

Provided that this regulation shall not apply where a combined balance-sheet is issued incorporating the assets and liabilities of the insurer whose policies are guaranteed.

5. Where any part of the assets of an insurer is deposited in any place outside India as security for the owners of policies issued in that place, the balance-sheet shall state that part of the assets has been so deposited, and, if any such part forms part of the life insurance fund, shall show the amount thereof and the place where it is deposited. Where any combined balance-sheet is issued by an insurer for any purpose, the information required by this regulation shall be shown in the aggregate in respect of all the insurers whose assets and liabilities have been incorporated in the balance-sheet.

6. There shall be appended to the balance-sheet a statement in Form AA as set out in Part II of this Schedule showing the market value and the book value of the assets in India.

7. Every balance-sheet shall contain the following certificates, namely:—

(*a*) a certificate signed by the same persons as are required by this Act to sign the balance-sheet explaining how the values as shown in the balance-sheet of the Investments in Stocks and Shares have been arrived at, and how the market value thereof has

been ascertained for the purpose of comparison with the values so shown;

(*b*) a certificate signed by the same persons as are required by this Act to sign the balance-sheet and signed also, so far as respects the value of any items shown in the balance-sheet under the heading of "Reversions and Life Interests", by an actuary, certifying that the values of all the assets have been reviewed as at the date of the balance-sheet, and that in their belief the assets set forth in the balance-sheet are shown in the aggregate at amounts not exceeding their realisable or market value under the several headings—"Loans", "Reversions and life Interests", "Investments", "Agent's Balances", "Outstanding Premiums", "Interest, Dividends and Rents outstanding", "Interest, Dividends and Rents accruing but not due", "Amounts due from other Persons or Bodies carrying on Insurance Business", "Sundry Debtors", "Bills Receivable", "Cash" and the several items specified under "Other Accounts":

Provided that if the persons signing the certificate are unable to certify that the assets set forth in the balance-sheet are so shown as aforesaid, a full explanation of the bases upon which the values shown in the balance-sheet have been assessed shall be given in the certificate;

(*c*) where the balance-sheet relates either wholly or in part to life insurance business, a certificate signed by the same persons as are required by this Act to sign the balance-sheet and by the auditor certifying that no part of the assets of the life insurance fund has been directly or indirectly applied in contravention of the provisions of this Act relating to the application and investment of life insurance funds; and

(*d*) certificates signed by the auditor (which shall be in addition to any other certificate or report which he is required by law to give with respect to the balance-sheet) certifying—

(*i*) that he has verified the cash balances and the securities relating to the insurer's loans, reversions and life interests, and investments;

(*ii*) to what extent, if any, he has verified the investments and transactions relating to any trusts undertaken by the insurer as trustee; and

(*iii*) in the case of a combined balance-sheet, that he has audited the balance-sheet and accounts of every insurer whose assets and liabilities are incorporated therein, or that any such balance-sheet and accounts which have not been audited by him have been certified by independent auditors. The said certificates shall contain a reference to such reservations, if any, as may have been made by any auditor upon any report or certificate given by him with respect to the balance-sheet

and accounts of any insurer whose assets and liabilities are incorporated in the combined balance-sheet.

8. If the values shown in the balance-sheet in respect of "Holdings in Subsidiary Companies" or "House property (*i*) in India (*ii*) out of India" have been increased since the last previous balance-sheet, the certificate required by paragraph (b) of the last foregoing regulation shall state the amount of every increase not solely due to the cost of subsequent additions or, as respects holdings in controlled companies, to increased profits, and shall contain an explanation of the reason therefor.

9. For the purposes of this Schedule the following expressions have the meanings hereby respectively assigned to them, namely:—

(*a*) "combined balance-sheet" includes any combined statement made by an insurer of assets and liabilities in the form of a balance-sheet which includes the assets and liabilities of any other insurer; and

(*b*) "market value" means as respects any assets the market value thereof as ascertained from published market quotations, or, if there be no such value, its fair value as between a willing buyer and a willing seller.

PART II—FORMS

FORM A

Form of Balance-Sheet

Balance-Sheet of 19

	Life and Annuity Bussiness (1)	Other Classes of Business (2)*	Total		Life and Annuity Bussiness (1)	Other Classes of Business (2)*	Total
	Rs. nP.	Rs. nP.	Rs. nP.		Rs. nP.	Rs. nP.	Rs. nP.
Shareholders' capital (each class to be stated separately)				LOANS:			
AUTHORISED:				On Mortgages of property within India			
.....shares of Rs.....each Rs. ———				On Mortgages of property outside India			
SUBSCRIBED:				On security of municipal and other public rates ..			
.....shares of Rs.....each Rs. ———				On Stocks and Shares ..			
CALLED UP:				On Insurer's Policies within their surrender value ..			
.....shares of Rs.....each Rs. ———				On personal security ..			
Less: Unpaid calls Rs.———				To Subsidiary Companies (other than Reversionary) (f)			
Reserve or Contingency A/c (*a*):				Reversions and Life Interests purchased			

Rent Reserve Account				Loans on Reversions and Life Interests ..				
Profit and Loss Appropriation Account Balance ..				Debentures and Debenture stocks of Subsidiary Reversionary Companies (*f*) ..				
BALANCES OF FUNDS AND ACCOUNTS:				Ordinary Stocks and Shares of Subsidiary Reversionary Companies (*f*)				
Life Insurance Fund—								
(*i*) Business in India ..								
(*ii*) Business outside India								
				Loans to Subsidiary Reversionary Companies (*f*) ..				
Fire Insurance Business A/c.				INVESTMENTS:				
Marine Insurance Business Account				Deposit with the Reserve Bank of India (securities to be specified)				
Miscellaneous Insurance Business Account. (*m*)								
Other accounts, if any (to be specified (*i*)				Indian Government Securities State Government Securities, British, British Colonial and British Dominion Government Securities ..				
Pension or Superannuation Accounts (*b*)								
Debenture Stock per cent ..								
LOANS AND ADVANCES (*c*) ..				Foreign Government Securities				
Bills payable (*c*) ..				Indian Municipal Securities				
Estimated Liability in respect of outstanding claims, whether due or intimated (*d*)				British and Colonial Securities				
				Foreign Securities ..				

FORM A—*contd.*

	Life and Annuity Bussiness (1)	Other Classes of Business (2)*	Total		Life and Annuity Bussiness (1)	Other Classes of Business (2)*	Total
	Rs. nP.	Rs. nP.	Rs. nP.		Rs. nP.	Rs. nP.	Rs. nP.
Annuities due and unpaid (*d*)				Bonds, Debentures, Stocks and other Securities whereon Interest is guaranteed by the Indian Government or a State Government ..			
Outstanding Dividends ..							
Amounts due to other Persons or bodies carrying on Insurance Business (*c*) ..							
Sundry Creditors (including outstanding and accruing expenses and Taxes) (*c*) ..				Bonds, Debentures, Stocks and other Securities whereon interest is guaranteed by the British or any Colonial Government			
Other sums owing by the Insurer (particulars to be given) (*c*)				Bonds, Debentures, Stocks and other Securities whereon Interest is guaranteed by any Foreign Government ..			
Contingent Liabilities (to be specified) (*e*)							
Rs.———				Carried over			

			Brought Forward ..		
			Debentures of any railway in India		
			Debentures of any railway out of India		
			Preference or guaranteed Shares of any railway in India		
			Preference or guaranteed Shares of any railway out of India		
———	———	———	Railway Ordinary Stocks (*i*) in India (*ii*) out of India ..		
———	———	———	Other Debentures and Debenture Stock of Companies incorporated (*i*) in India (*ii*) out of India		
			Other guaranteed and preference Stocks and shares of Companies incorporated (*i*) in India (*ii*) out of India .		
			Other Ordinary Stocks and Shares of companies incorporated (*i*) in India (*ii*) out of India		
			Holdings in Subsidiary Companies (*f*) House property (*i*) in India (*ii*) out of India		

FORM A—*Contd.*

	Life and Annuity Business (1)	Other Classes of Bussiness (2)*	Total		Life and Annuity Business (1)	Other Classes of Business (2)*	Total
	Rs. nP.	Rs. nP.	Rs. nP.		Rs. nP.	Rs. nP.	Rs. nP.
				Freehold and Leasehold ground rents and rent charges			
				Agent's Balances			
				Outstanding Premiums (*g*)/(*d*)			
				Interest, Dividends and Rents outstanding (*d*) ..			
				Interest, Dividends and Rents accruing but not due (*d*) ..			
				Amounts due from Other Persons or Bodies carrying on Insurance Business (*h*) ..			
				Sundry Debtors (*i*) ..			
				Bills Receivable			
				CASH:			
				At Bankers on Deposit Account			
				At Bankers on Current Account and in hand.			

			At Call and Short Notice (*j*) . .			
			Other Accounts (to be specified) (*k*)			

*Assets and Liabilities, shareholders' Capital and Reserves, not allocated to any class of business specified in column (1) must be shown in column (2)

NOTES

(*a*) The Reserves or Contingency Accounts must be separately stated.

(*b*) If the insurer has not full and unrestricted control of the assets constituting the Pension or Superannuation Accounts, either those Accounts and the assets and liabilities relating thereto must be omitted from the balance-sheet or the assets of which the insurer has not such control must be clearly indicated on the face of the balance-sheet.

(*c*) If the insurer has deposited security as cover in respect of any of these items, the amount and nature of the securities so deposited must be clearly indicated on the face of the balance-sheet.

(*d*) These items are or have been included in the corresponding items in the Revenue or Profit and Loss Account. Outstanding and accruing interest, dividends and rents must be shown after deduction of income-tax or the income-tax must be provided for amongst the liabilities on the other side of the balance-sheet.

(*e*) Such items as amount of liability in respect of bills discounted, uncalled capital of subsidiary companies, uncalled capital of other investments, etc., must either be shown in their several categories under the heading "Contingent Liabilities" or the appropriate items on the assets side must be set out in such details as will clearly indicate the amount of the uncalled capital.

(*f*) As respects life and annuity business full particulars of holdings in and loans to subsidiary companies must be stated, giving the name of each company, the number and description of each class of shares held the amounts paid up thereon and the value at which the holding in each company stand in the balance sheet.

(*g*) Either this item must be shown net or the commission must be provided for amongst the liabilities on the other side of the balance-sheet.

(*h*) The aggregate amount owing by a subsidiary company or subsidiary companies is to be shown separately from all other assets and the aggregate amount owing to a subsidiary company or subsidiary companies is to be shown separately from all other liabilities.

(*i*) Amounts due from directors and officers must be shown separately.

(*j*) No amounts must be entered under this heading unless fully secured. If not fully secured, the amounts must be included under the heading "Sundry Debtors".

(*k*) Under this heading must be included such items as the following, which must be shown under separate headings suitably described: Office-furniture, goodwill, preliminary, formation and organisation expenses, development expenditure account, discount on debentures issued, other expenditure carried forward to be written off in future years, balance being loss on Profit and Loss Appropriation Accounts, etc. The amounts included in the balance-sheet must not be in excess of cost.

(*l*) Under the head, "Other accounts, if any (to be specified)," on the left hand side, fines realised from the staff and their contribution towards the provident fund, if any, should be shown under separate sub-heads.

(*m*) Where the insurer is required to maintain a separate account in respect of any sub-class of miscellaneous insurance business this heading is to be split up accordingly.

(The First Schedule)

FORM AA

Classified Summary of the Assets in India of the.....Company on 19..

Class of Asset	Book value as per (*a*) below	Market value as per (*b*) below	Remarks as per (*c*) below
(1) Government of India Securities.	Rs.	Rs.	
(2) Indian State Government Securities.			
(3) Indian Municipal Port and Improvement Trust Securities including Debentures.			
(4) Debentures of Indian Railways.			
(5) Guaranteed and Preference Shares of Indian Railways.			
(6) Annuities of Indian Railways.			
(7) Ordinary Shares of Railways in India.			
(8) Other Debentures of concerns in India.			
(9) Other Guaranteed and Preference Shares of concerns in India.			
(10) Other Ordinary Shares of concerns in India.			
(11) Loans on the Company's policies effected in India and within their surrender value.			
(12) Loans on Mortgage of property in India.			
(13) Loans on Personal Security to persons domiciled and resident in India.			
(14) Other loans granted in India (particulars to be stated).			
(15) Land and House property in India.			
(16) Cash on Deposit in Banks in India.			
(17) Cash in hand and on current account in banks in India.			
(18) Agents' balances and outstanding premiums.			
(19) Interest, dividends and rents either outstanding or accrued but not due.			
(20) Other assets in India (to be specified).			

FORM AA—contd.

The statement shall show—

(*a*) the value for which credit is taken in the balance-sheet for each of the abovementioned classes of assets

(*b*) the market value of such of the abovementioned classes of assets as has been ascertained from published quotations after deduction of accrued interest included in market prices in those cases where accrued interest is included elsewhere in the balance-sheet.

(*c*) how the value of such of the abovementioned classes of assets as has not been ascertained from published quotations has been arrived at, and

(*d*) the rates of exchange at which the values of the assets other than in rupee currency have been converted into rupees.

The market values need not be shown separately where they are not less than the book values and a certificate to that effect is appended to the statement.

No amounts on account of any of the following items may be entered in the statement:—

Goodwill.

Preliminary, formation, organisation or development expenses

Commission or discount on shares or debentures issued.

Commuted Commission.

Expenditure carried forward to be written off in future years.

THE SECOND SCHEDULE

(*See* Section 11.)

REGULATIONS AND FORMS FOR THE PREPARATION OF PROFIT AND LOSS ACCOUNTS

PART I.—*Regulations*

1. The items on the income side of the Profit and Loss Account and Profit and Loss Appropriation Account must relate to income whether actually received or not, and the items on the expenditure side must relate to expenditure whether actually paid or not.

2. Deductions from Interest, Dividends and Rents to be shown in respect of income-tax must include all amounts in respect of Indian (Central) income-tax whether or not it has been or is to be deducted at source or paid direct.

3. The interest, Dividends and Rents, *less* income-tax thereon shown in the Revenue Accounts for any classes of business other than life insurance business, including annuity business may, if the insurer so desires, be included with the corresponding items in the Profit and Loss Account

(The Second Schedule)

Part II.—*Forms*

FORM B

Form of Profit and Loss Account

Profit and Loss Account of.....for the year ended 19.....

	Rs. nP.		Rs. nP.
Indian (Central) Taxes on the Insurer's Profits (not applicable to any particular Fund or Account)		Interest, Dividends and Rents (not applicable to any particular Fund or Account) Rs. Less:—Income-tax thereon Rs.	
Expenses of Management (not applicable to any particular Fund or Account)*		Profit on realisation of Investments (not credited to Reserves or any particular Fund or Account)	
Loss on Realisation of Investments (not charged to Reserves or any particular Fund or Account)		Appreciation of Investments (not credited to Reserves or any particular Fund or Account)	
Depreciation of Investment (not charged to Reserves or any particular Fund or Accoount)		Profit transferred from Revenue Accounts (details to be given)	
Loss transferred from Revenue Accounts (details to be given)		Transfer Fees	
Other Expenditure (to be specified)		Other Income (to be specified)	
Balance for the year carried to Appropriation Account		Balance being loss for the year carried to appropriation Account	

*If any sum has been deducted from this item and entered on the assets side of the balance-sheet, the amount must be shown separately.

FORM C

Form of Profit and Loss Appropriation Account

Profit and Loss Appropriation Account of....for the year ended 19....

	Rs. nP.		Rs. nP.
Balance being loss brought forward from last year ..		Balance brought forward from last year Rs.	
Balance being loss for the year brought from Profit and Loss Account (as in Form B) ..		Less—Dividends since paid in respect of last year (to be specified and if "free of tax" to be so stated)† Rs.	
Dividends paid during the year on account of the current year (to be specified and if "free of tax" to be so stated)			
		Balance for the year brought from Profit and Loss Account (as in Form B) ..	
Transfers to any particular Funds or Accounts (details to be given)			
		Balance being loss at end of the year as shown in the Balance-Sheet	
Balance at end of the year as shown in the Balance-Sheet			

†NOTE.—This item may be shown on the other side of the account if preferred.

THE THIRD SCHEDULE

(*See* section 11.)

REGULATIONS AND FORMS FOR THE PREPARATION OF REVENUE ACCOUNTS.

Part I.—Regulations.

1. Form D is, as set out in Part II of this Schedule, appropriate for life insurance business, but a separate revenue account must be prepared for every class or sub-class of business in respect of which the insurer is required to maintain a separate account.

2. Form F is, as set out in Part II of this Schedule, appropriate for fire insurance and for Marine insurance business. A separate revenue account in the same form must be prepared for miscellaneous insurance exclusive of any sub-class of such business in respect of which the insurer is required to maintain a separate account.

For a sub-class of miscellaneous insurance in respect of which the insurance is required to maintain a separate account, Form D or Form F as set out in Part II of this Schedule may be used with such modifications as the Controller may authorise.

3. If any combined revenue account is for any purpose issued by an insurer it must be in accordance with the forms specified in this Schedule and must clearly show on the face thereof that it is a combined revenue account, and must set out fully the name of every insurer required to make separate returns under this Act, whose revenue and expenditure have been included therein; if the revenue and expenditure of any person not being an insurer are included in a combined revenue account, the fact must be stated thereon.

4. The items on the income side of the revenue account must relate to income whether actually received or not, and the items on the expenditure side must relate to expenditure whether actually paid or not.

5. Re-insurance premiums, whether on business ceded or accepted, are to be brought into account gross (*i.e.*, before deducting commissions) under the head premiums.

6. As respects life insurance business the following statements shall be furnished to the Controller every year showing details provided for in a Form pertaining thereto:—

(A) A statement in Form DD as set forth in Part II of this Schedule.
(B) A statement in Form DDD as set forth in Part II of this Schedule.
(C) A statement in Form DDDD as set forth in Part II of this Schedule.

7. In addition to the revenue account, information shall be supplied of the gross premium written direct in India, that is, the premium income without taking into account premiums on reinsurances ceded or accepted,

for every class or sub-class of business in respect of which the insurer is required to maintain a separate account.

7A. In addition to the revenue account, information shall also be supplied of the gross claims payable directly by the insurer in India (that is to say, the claims without taking into account claims on reinsurance ceded or accepted) separately for fire, marine and miscellaneous insurance business and the provisions of sections 20 and 116A shall not apply to any information so supplied.

8. Any office premises which form part of the assets of a life insurance fund must be treated as an interest earning investment, and accordingly, in the revenue account for life insurance business a fair rent for the premises must be included under the heading "Interest, Dividends and Rents" and in the revenue account for every class of business for which the premises are used proper charges for the use thereof must be included under the heading "Expenses of Management".

9. Where an insurer carries on the business of life insurance in conjunction with any other class of insurance business the expenses of management charged to the life insurance revenue account must not include more than a reasonable proportion of the common expenses and in particular, no such account must be charged with more than a fair sum for the use of any office premises having regard to the income from the various classes of business carried on and to the extent to which the premises are used for the purposes of each class of business.

10. Deductions from Interest, Dividends and Rents in respect of income-tax must include all income-tax charged on such income whether or not it has been or is to be deducted at source or paid direct; the income-tax to be shown as so deducted in the life insurance Revenue Account is Indian (Central), Indian (State), United Kingdom. Foreign and Dominion income-tax, but the income-tax to be shown as deducted in Revenue Accounts of any other classes of business is Indian (Central) income-tax only.

(The Third Schedule)

Part II.—Forms

FORM D

Form of Revenue Account applicable to Life Insurance Business

Revenue Account of.....for the year ended.....19....

in respect of.....Business.

———	Business within India.	Business out of India(*a*)	Total	———	Business within India.	Business out of India(*a*)	Total
	Rs.	Rs.	Rs.		Rs.	Rs.	Rs.
Claims under Policies (including provision for claims due or intimated), less Re-insurances				Balance of Fund at the beginning of the year ..			
By death				Premiums, less Re-insurances			
By maturity				(*i*) First year premiums, where, the maximum			

(*The Third Schedule*)

FORM D—*contd.*

——	Business within India.	Business out of India(*a*)	Total	——	Business within India.	Business out of India(*a*)	Total
	Rs.	Rs.	Rs.	premiums-paying period (*g*) is—	Rs.	Rs.	Rs.
Annuities, less Re-insurances				two years ——			
				three years ——			
Surrenders (including Surrenders of Bonus) less Re-insurances				four years ——			
				five years ——			
				six years ——			
				seven years ——			
				eight years ——			
Bonuses in Cash less Re-insurances				nine years ——			
				ten years ——			
				eleven years ——			
Bonuses in Reduction of Premiums, less Re-insurances ..				twelve years or over (including throughout life) ——			
				(*ii*) Renewal premiums			

Expenses of Management (*b*)-				(*iii*) Single premiums ..			
1. (*a*) Commission to Insurance agents (less that on Re-insurances)				Consideration for Annuities granted, less Re-insurances (*c*)			
(*b*) Allowances and Commission (other than commission included in sub-item (*a*) preceding)				Interest, Dividends and Rents			
				Less—Income-tax thereon (*d*)			
				Registration Fees			
				Other Income (to be specified) (*e*)			
				Loss transferred to Profit and Loss Account			
				Transferred from Appropriation Account ..			
2. Salaries, etc. (other than to agents and those contained in item No. 1) ..							
3. Travelling expenses ..							
4. Directors' fees ..							
5. Auditors' fees							
6. Medical fees							
7. Law charges							
8. Advertisements ..							
9. Printing and Stationery							

(*The Third Schedule*) FORM D—*contd.*

	Business within India.	Business out of India(*a*)	Total		Business within India.	Business out of India(*a*)	Total
10. Other expenses of management (accounts to be specified)							
11. Rents for offices belonging to and occupied by the insurer							
12. Rents of other offices occupied by the insurer							
Bad Debts							
United Kingdom, Indian, Dominion and Foreign Taxes							
Other Expenditure (to be specified)							
Profit transferred to Profit and Loss Account ..							
Balance of Fund at the end of the year as shown in the Balance-Sheet ..							
Rs. ..				Rs.			

(The Third Schedule)

NOTES

(*a*) These columns apply only to business the premiums in respect of which are ordinarily paid outside India.

If any question arises whether any premiums are ordinarily paid outside India, the Controller shall decide the question and his decision shall be final.

(*b*) If any sum has been deducted from this item and entered on the assets side of the balance-sheet, the amount so deducted must be shown separately. Under this item the salary paid to the managing agent or managing director shall be shown separately from the total amount paid as salaries to the remaining staff.

(*c*) All single premiums for annuities. whether immediate or deferred, must be included under this heading.

(*d*) Indian, United Kingdom, Foreign and Dominion income-tax on Interest, Dividends and Rents must be shown under this heading, less any rebates of income-tax recovered from the revenue authorities in respect of expenses of management. The separate heading on the other side of the account is for United Kingdom, Indian, Foreign and Dominion taxes, other than those shown under this item.

(*e*) Under the head "Other Income" fines, if any, realised from the staff must be shown separately. All the amounts received by the insurer directly or indirectly whether from his head office or from any other source outside India shall also be shown separately in the revenue account except such sums as properly appertain to the capital account.

(*f*) In the case of an insurer having his principal place of business outside India the expenses of management for business out of India and total business need not be split up into the several sub-heads, if they are not so split up in his own country.

(*g*) Where the maximum premiums-paying period includes a fraction of a year, such fraction shall be ignored for the purposes of this revenue account.

(The Third Schedule)

FORM F

Form of Revenue Account applicable to Fire Insurance Business, Marine Insurance Business and Miscellaneous Insurance Business

Revenue Account of.....for the year ended.....19..... in respect of Business.

	Rs.		Rs.
Claims under Policies, less Reinsurances (*a*) (*d*):		Balance of Account at begining of the year: ..	
Paid during the year .. Rs.		Reserve for Unexpired Risks .. .. Rs.	
Total estimated liability in respect of outstanding claims at end of the year whether due or intimated .. Rs.		Additional Reserve (if any) .. .. Rs.	
Total ..		Premiums, less Re-insurances (*d*) ..	
Less—Outstanding at end of Previous year (*b*) .. .. Rs.		Interest, Dividends and Rents .. .. Rs.	
Commission on direct Business		Less—Income-tax thereon .. .. Rs.	
Commission on Re-insurances accepted ..		Commission on Re-insurances ceded ..	
Expenses of management (*c*)			
Bad Debts		Other Income (to be specified) (*e*) ..	
United Kingdom, Indian, Dominion and Foreign Taxes		Loss transferred to Profit and Loss Account ..	
Other Expenditure (to be specified) ..		Transferred from Appropriation Account ..	
Profit transferred to Profit and Loss Account ..			
Balance of Account at the end of the year as shown in the Balance-Sheet			
Reserve for Unexpired Risks being per cent. of premium income of year .. .. Rs.			
Additional Reserve (if any), ... Rs.			
Rs.		Rs.	

NOTES

(*a*) This heading must include all expenses directly incurred in settling claims.

(*b*) If in any year the claims actually paid and those still unpaid at the end of that year in respect of the previous year or years are in excess of the amount included in the previous year's Revenue Account as provision for outstanding claims, then the amount of such excess must be shown in the Revenue Account.

(*c*) If any sum has been deducted from this item and entered on the assets side of the balance-sheet the amount so deducted must be shown separately.

(*d*) Where the account is furnished under the provisions of section 11 of the Insurance Act, 1938, separate figures for claims paid to claimants in India and claimants outside India, and for premiums derived from business effected in India and effected outside India must be given.

(*e*) All the amounts received by the insurer directly or indirectly whether from this head office or from any other source outside India shall also be shown separately in the revenue account except such sums as properly appertain to the capital account.

Where the account is furnished under the provisions of clause (*b*) of sub-section (2) of section 16 of the Insurance Act, 1938, by an insurer to whom that section applies, separate figures for business within India and business out of India must be given against the items marked with an asterisk. Against all other items the total amount for the business as a whole may be given.

The accounts and statements referred to in Section 11(*1*) are required to be signed by the insurer or in the case of a company by the chairman, if any, and two directors and the principal officer of the company, or in the case of a firm by two partners of the firm.

Section 15 provides that the audited accounts and statements should be printed and four copies thereof signed in the prescribed manner should be furnished as returns to the Controller within the prescribed time limit.

(M) *Audit.*

Section 12 provides as under:—

The balance sheet, profit and loss account, revenue account and profit and loss appropriation account of every insurer, in the case of an insurer specified in sub-clause (*a*) (*ii*) or sub-clause (b) of clause (9) of section 2 in respect of all insurance business transacted by him, and in the case of any other insurer in respect of the insurance business transacted by

him in India, shall, unless they are subject to audit under the Indian Companies Act, 1913, be audited annually by an auditor, and the auditor shall in the audit of all such accounts have the powers of, exercise the functions vested in, and discharge the duties and be subject to the liabilities and penalties imposed on, auditors or companies by section 145 of the Indian Companies Act, 1913.

Under Section 104, whoever, in any return, report, certificate, balance sheet or other document, required by or for the purposes of any of the provisions of the Act, wilfully makes a statement false in any material particular, knowing it to be false, is punishable with imprisonment or fine or both.

The companies carrying on general insurance business are required to observe the code of conduct laid down by the general insurance council. Apart from the statutory audit, the accounts of such companies are also examined by auditors appointed by the general insurance council to check compliance with the code of conduct.

(N) *Insurers outside India.*

Section 16 makes provision in respect of returns by insurer established outside India.

The requirements of Section 64, in regard to the books to be kept by insurers established outside India are as under:—

Every insurer having his principal place of business or domicile outside India shall keep at his principal office in India such books of account, registers and documents as will enable the accounts, statements and abstracts which he is required under this Act to furnish to the Controller in respect of the insurance business transacted by him, in India to be compiled and, if necessary, checked by the Controller and shall furnish to the Controller on or before the last day of January in every calendar year a certificate from an auditor to the effect that the said books of account, register and documents are being kept as required at the principal office of the insurer in India.

(O) *Auditor's Duty.*

In addition to the general procedure which has been dealt with at length in preceding chapters, special points which arise for consideration in case of audit of insurance companies are discussed hereunder.

In the case of an insurance company it is not possible for an auditor to examine the whole of the transactions in detail and

hence it is necessary for him to examine whether the system of internal check and control is adequate. He should decide upon the scope of his examination having regard to the nature and extent of the internal check in force.

The auditor should check the cash book and vouch the receipts and the payments. The premium receipts should be traced from the policy registers for direct and re-insurance business. The claims paid should be traced into the claims register. The bank pass-books should be checked and the bank balances should be verified with reference to the certificates of the banks obtained directly by the auditor. He should also verify the cash on hand.

The auditor should vouch the premium income with the premium register from which it should be possible to verify the premium income in total by taking the totals of the direct premiums after adjusting extra premiums and refunds and adding thereto the premiums on re-insurances accepted and deducting therefrom the premiums paid on re-insurance ceded.

The claims paid and payable should be checked with the claims register. In respect of direct claims, he should see the party's claim form, copy of the policy, surveyor's report, vouchers for expenses and discharge voucher. The legal expenses incurred in respect of claims should be debited to the Claims Account and not to Legal Charges Account. When the claim is paid, it must be seen whether any rights are acquired against third party by virtue of subrogation and it must be seen whether steps are taken to recover the claims from such third parties. In case of re-insurance claims the circular from the company concerned together with the surveyor's report will be available for verification. The re-insurance recoveries should be checked and it should be ascertained that all outstandings on this account are provided for.

As regards outstanding claims, he should see that the claims intimated and accepted as well as claims intimated but not accepted are duly provided for and that the relative re-insurance recoveries are taken into account. In case of disputed claims the liability should be estimated on a reasonable basis.

The agents' commissions should be vouched with the receipts, agent's accounts, etc., and it should be seen that provision has been made for any commission outstanding. Some of the accounts in the Agents' Ledger should be tested with the returns from the

agents. While vouching the commission it should be noted that the rate prescribed by the Act is not exceeded. The commission payable on direct business procured by agents may be reconciled with the premiums received on such business. In respect of agents' balances which are considered bad or doubtful adequate provision should be made.

In the case of re-insurance companies, the treaties with the ceding companies should be examined, with particular reference to any provisions under which the ceding company is entitled to retain funds as security for the fulfilment of the treaties. Where this is the case, certificates should be obtained from the companies concerned of the funds held by them, and they should appear separately in the balance sheet of the re-insurance company as amounts due from other persons or bodies carrying on insurance business. In case of treaties with re-insurance companies, it should be seen whether the profit commission to which a direct insurer is entitled to, is taken into account.

The accounts of the ceding companies should be tested and the outstanding balances agreed; similarly, treaties made by the re-insurance company with other companies, under which they may concede a portion of the re-insurances received by them should be examined, together with the accounts relative thereto.

The auditor should ascertain that the items on the income side of the revenue account must relate to income whether actually received or not and the items on the expenditure side must relate to expenditure whether actually paid or not.

The expenses of management should be carefully scrutinized and it should be seen that all expenses of management wherever incurred, whether directly or indirectly have been fully debited in the revenue account as expenses. In the case of an insurer having his principal place of business outside India, the head office expenses for the purposes of Section 40C of the Act should not be less than five per cent. of the gross premium income written direct in India during the year. Where the expenses of management are shared by different departments, it should be seen that the apportionment of expenses is made on a reasonable and equitable basis.

The auditor should ensure that interest and dividends on investments have been duly collected and the outstanding income in respect thereof is brought into account.

The adequacy of the reserves for unexpired risks should be fully inquired into, having regard to the nature of the business transacted and the past experience of the company. Such reserve is computed with reference to the net premium income of the company.

The auditor should verify the investments of the company and see that the market value thereof is correctly ascertained. The balance sheet must state how the values of the investments in stocks and shares have been arrived at and how the market value thereof has been ascertained for the purpose of comparison with the values so shown. The auditor must also verify the balances with the banks, deposits with the Reserve Bank of India and the cash on hand. The agents' balances should be checked with the confirmations obtained from the agents.

The auditor should ascertain that all the contingent liabilities have been properly disclosed and shown under appropriate headings.

The annual accounts should be prepared in accordance with the regulations and forms prescribed for the preparation of balance sheet, revenue accounts and profit and loss account. The regulations for preparation of accounts contain detailed instructions as to the manner in which such accounts are to be prepared and the same should be carefully followed by the auditor.

It should be noted that under the First Schedule to the Act, the auditor, in addition to any other certificate or report which he is required by law to give, with respect to balance sheet, is required to certify: (*i*) that he has verified the cash balances and the securities relating to the insurer's loans and investments, (*ii*) to what extent, if any, he has verified the investments and transactions relating to any trust undertaken by the insurer as trustee.

CHAPTER XIV

SPECIAL POINTS IN DIFFERENT CLASSES OF AUDITS

In addition to the general procedure which has been dealt with at length in preceding chapters, special points arise for consideration in each different class of audit. It is not possible, owing to the limits of available space, to deal with every kind of business, or to discuss in detail the various special matters that have to be considered. In the following pages the important points that require the auditor's attention in a representative number of cases are considered.

§ 1. Branch Accounts

In the case of a business possessing branches, the auditor should ascertain the system by which the branch accounts are kept, and the manner in which they are incorporated in the head office books. Where the auditor does not visit all the branches, he should enquire carefully into the internal control over the activities and records of the branch and examine the returns furnished by them, which should in each case be duly certified by the branch manager, and ascertain that they are properly incorporated in the head office books. The auditor should in such a case state in his report that he has accepted the certified returns sent from certain branches.

The auditor should, however, satisfy himself that all questions of principle, such as the valuation of stocks, provisions for depreciation, bad debts, etc., have been properly dealt with by the branches.

In the case of retail branches it is usual to find goods supplied by the head office charged out either at cost price, at cost price plus a fixed percentage, or at selling price, stocks in each case n on a similar basis, and in the two last cases the audi- l see that the values of the stocks have been reduced to nder for Balance Sheet purposes. Schedules of debtors

at the branch should be submitted, duly certified, and the auditor should ascertain that all liabilities at the branch not already shown in the head office books have been brought into account.

The balances on the branch accounts will in such cases usually be represented by stock on hand, sundry debtors, and cash in hand, and for the purpose of the final Balance Sheet the branch balances must be incorporated in the amounts of the particular assets of which they are respectively composed.

Where a complete set of books is kept at each branch, and only a current account with the branch is kept in the head office books, the auditor should have produced to him either the Trial Balance of the branch or the branch Profit and Loss Account and Balance Sheet. In such a case the balance of the Branch Current Account in the head office books will represent the capital employed at the branch, and will be made up of the assets less the liabilities appearing in the branch books. These should be incorporated in the final Balance Sheet under their respective headings. In no case should the balance to the debit of the Branch Account be treated as a debtor.

All cash remitted from the branch, as shown by the branch accounts, should be vouched into the head office books, and similarly all cash remitted from the head office should be vouched into the branch accounts. Items of cash or stock in transit should be vouched by ascertaining that they have been received subsequently.

In the case of foreign branches the question of exchange will arise in addition to the above-mentioned points, and the auditor should check the conversion of the various items into rupees, and ascertain that the difference on exchange has been properly dealt with. Where the exchange is of a fluctuating character, the following rule is frequently adopted: fixed assets are converted at the rate prevailing when they were acquired, if purchased out of currency funds, or at the cost of a special remittance sent by the head office for the acquisition; current assets and liabilities at the rate at the date of the Balance Sheet; revenue items at the average rate of the period covered by the accounts; and remittances at the actual rates.

If each item of the Trial Balance is converted at its appropriate rate, the opening balance of the Head Office Current Account be-

ing replaced by the rupee figure at which it stands in the head office books, the difference on the rupee Trial Balance will represent the total difference on exchange. If the difference represents a loss, it should be written off; if a profit, it may be advisable to carry it forward against possible losses arising in a succeeding period.

Various other methods may be met with, and in each case the auditor must satisfy himself that the treatment employed is proper under the circumstances; if this is not so, he should deal with the matter in his report to the members.

The accounts should disclose the basis on which foreign currencies have been converted into rupees where the amount affected is material.

In all cases where the auditor accepts certificates of officials or other persons for the verification of assets at branches, he should mention that he has done so in his report.

In the case of a concern carrying on business abroad where the foreign branches are not visited by the auditor, he must state in his report that proper returns adequate for the purpose of the audit have been received.

In case of a *company,* the appointment of branch auditors and their powers and duties have been considered in Chapter VII § 1.

§ 2. Charities

The auditor should ascertain the legal status of the charity and see whether it is public or private. In case the charity is a public trust he should note the provisions of State Legislation, if any, affecting the accounts and audit.

The auditor should examine the trust deed or other documents setting out the objects of the charity and satisfy himself that all expenditure is in accordance therewith.

The income from donations and subscriptions should be checked into the Cash Book from the counterfoil Receipt Books. The auditor should see that all spoilt receipts are produced. The receipts should be printed with the name of the charity, and numbered consecutively.

If there is a printed list of subscriptions and donations this should be checked and agreed with the total shown in the accounts.

It should be seen that all funds left for specific purposes have been applied to those purposes.

The receipts from legacies should be vouched with the Legacy Register, correspondence with the solicitors, etc. Other income from investments, rents, etc., should be vouched in the manner described in Chapter II.

He should see whether there are any directions in the trust deed, or any donations are given on conditions in regard to earmarking of funds, investments thereof or utilisation of income therefrom. In such cases it should be seen that such directions have been duly complied with. The expenditure should be carefully vouched, having regard to the distinction between capital and revenue expenditure. Transactions with trustees or firms in which they are interested should be carefully examined. He should inspect the minute book of the trustees or the executive body for confirming all important matters and transactions affecting accounts.

As charitable institutions are usually not liable to income-tax, it should be seen that no tax has been paid, or where it has been paid by deduction, that it is duly recovered.

The assets and liabilities of the charity at the date of the Balance Sheet should be verified in the usual manner.

The auditor should see that the annual accounts are prepared in proper forms and in accordance with the requirements of Act and rules, if any. The auditor's certificate must also conform to the prescribed form, if any.

§ 3. Clubs

The auditor should examine the rules and regulations of the club with a view to ascertain its legal status and its constitution. The rules and regulations affecting the accounts and the powers of the managing or executive committee should be noted.

The entrance fees and annual subscription should be vouched with the counterfoil receipt books, if any, and the total verified with the annual list of members, enquiry being made into those in arrear.

The steward's receipts should be vouched, and it should be seen that there is an effective system of check as regards the dinning room, billiards, wines, cigars, etc. Proper stock accounts

should be kept of wines, cigars, etc., and any wines which are not the property of the club, but of wine merchants, should be specially recorded as such.

If the club owns or rents any amusement or other machines, the auditor must ensure that there is a proper system of control over the removal of coins from the machines. It should be seen that the sale proceeds of periodicals are properly accounted for.

The question of depreciation and renewals of china, glass, linen, plate, etc., is important. Where the original expenditure is capitalised, all renewals should be charged to revenue; but perhaps the best method is to take stock of these items, and re-value them on the occasion of each Balance Sheet. Where heavy expenditure is incurred from time to time in redecoration of the premises, it is advisable that an annual amount should be provided against each year's accounts, in order that this expenditure may be fairly equalised.

The assets and liabilities of the club at the date of the Balance Sheet should be verified in the usual manner. The auditor should inspect the minutes of the managing or executive committee for confirmation of important transactions and matters affecting accounts.

§ 4. Contractors

Under this heading may be included the accounts of contracting companies, builders, engineers, shipbuilders, etc., the bulk of whose work is carried out under contract conditions.

The auditor should examine the system of cost accounts in operation, as upon its efficiency will depend to a large extent the value of the accounts to the proprietors of the business. It is not within the province of this work to discuss in detail the question of cost accounts, but the auditor should ascertain the system of dealing with wages and expenditure on stores, materials, etc., and also the treatment of indirect expenditure, which is frequently termed establishment charges.

The item "Work-in-Progress" represents the value of uncompleted contracts at the date of the Balance Sheet, and a schedule showing how the amounts are arrived at should be presented to the auditor, duly certified. Where proper cost accounts have been kept, the auditor can check the expenditure on each contract

with the cost accounts relating thereto, otherwise he will be unable to verify the item, and will be obliged to accept it upon the certificate of the officials concerned.

The values placed upon work-in-progress should be compared with the latest available architect's, surveyor's or engineer's certificates, and where such comparison reveals that expenditure to date has exceeded the valuation certified, careful consideration should be given to the possibility of an eventual loss on the contract concerned, and the auditor should see that adequate provision has been made for such anticipated losses.

Where cost accounts are kept, the contract ledger for the succeeding period should be examined to see whether any expenditure has been incurred in respect of contracts treated as completed at the end of the previous year, and that if such expenditure has been incurred provision was made therefor at the date of the Balance Sheet. Careful consideration must be given to the question of liabilities to sub-contractors, and it must be seen, where work performed by sub-contractors has been included in certified valuations, that the amount due to the sub-contractors has been included in the value placed upon work-in-progress.

In view of the necessity for wages being paid at various sites, it is essential that the auditor should examine carefully the system of internal check in relation thereto.

Wages sheets should be tested exhaustively with workmen's time sheets and insurance cards. To reinforce the system of internal check, an occasional visit by the auditor to sites when wages are being paid is desirable, and great care should be taken in examining the records and the system of dealing with "pay offs" at sites.

Under the present day form of building contract, claims by the contractor frequently arise owing to prolongation of the contract by the customer, delay in obtaining specified materials, for increased costs and other similar reasons. Unless these claims have been settled before the conclusion of the audit, the auditor must satisfy himself that any credit taken therefor in the accounts has been calculated on a conservative basis. In cases where the amount is material and the auditor has doubts as to the final outcome of the claims in question, he should refer thereto in his report to the members.

The question as to whether it is desirable to take credit for profit in respect of uncompleted contracts is important. Where proper cost accounts are kept, it is possible to ascertain the profit to date by preparing a Profit and Loss Account in respect of each contract, which will be debited with all expenditure on the contract, in the shape of wages and materials, together with a proportionate allowance for indirect expenses, and credited with the proportion of work certified to date. A valuation must then be made of work done, but not yet certified, and stores and materials in hand on the contract, and after allowing for depreciation of plant used on the contract, the balance of the account, if in credit, should represent estimated profit to date. Another method, where contracts are nearly completed, is to estimate the cost of completion, and so arrive at the estimated figure of profit to date. Undoubtedly the safest method is not to take any profit until completion; but where profit is taken, the auditor should examine the method by which the estimated figure is arrived at, and see that ample margin is allowed for contingencies, at least one-third of the estimated profit being carried forward, regard also being had to the proportion of cash paid on account. In the case of a private firm, the matter is one for the decision of the partners; but in the case of a limited company, the auditor must take care to see that an ample margin for contingencies has been provided, and if necessary he must refer to the matter in his report. In all cases the auditor must see that the basis on which the work-in-progress has been valued is clearly shown in the accounts.

§ 5. Electricity Companies

Section 211(5), Companies Act, 1956, provides that in the case of a company engaged in the generation or supply of electricity, the Balance Sheet and the Profit and Loss Account shall not be treated as not disclosing a true and fair view of the state of affairs of the company, merely by reason of the fact that they do not disclose any matters which are not required to be disclosed by both the Indian Electricity Act, 1910 and the Electricity (Supply) Act, 1948.

Under Section 11, Indian Electricity Act, 1910, every licensee, unless expressly exempted from the liability by his licence, or by order in writing of the State Government, is required to prepare

and render to the State Government or to such authority as the State Government may appoint in this behalf, on or before the prescribed date in each year, an annual statement of accounts of his undertaking made up to such date, in such form, and containing such particulars, as may be prescribed in this behalf.

In the case of a company, however, for the purpose of placing the accounts before the shareholders, the requirements of Section 211 and Schedule VI, Companies Act, 1956, should be complied with.

Paragraph II of the Schedule to the Indian Electricity Act, 1910, contains provisions in regard to the audit of accounts of licensees other than a local authority. The said provisions in regard to audit apply only to the statements to be submitted by the licensee to the State Government.

Under paragraph III of the said Schedule, the licensee is required, unless the State Government otherwise directs, at all times, to keep the accounts of his undertaking relating to the generation, supply or distribution of energy, distinct from the accounts kept by him of any other undertaking or business.

According to Section 57, Electricity (Supply) Act, 1948, the Sixth Schedule and the Seventh Schedule are deemed to be incorporated in the licence of every licensee, not being a local authority, from the date of the commencement of supply. Sixth Schedule prescribes for a licensee, the financial principles and their application.

The Sixth Schedule is reproduced hereunder:—

THE SIXTH SCHEDULE

(*See* sections 57 and 57A)

FINANCIAL PRINCIPLES AND THEIR APPLICATION

I. Notwithstanding anything contained in the Indian Electricity Act, 1910 except sub-section (2) of section 22A, and the provisions in the licence of a licensee, the licensee shall so adjust his rates for the sale of electricity whether by enhancing or reducing them that his clear profit in any year of account shall not, as far as possible, exceed the amount of reasonable return:

Provided that such rates shall not be enhanced more than once in any year of account:

Provided further that the licensee shall not be deemed to have failed

so to adjust his rates if the clear profit in any year of account has not exceeded the amount of reasonable return by fifteen *per centum* of the amount of reasonable return:

Provided further that the licensee shall not enhance the rates for the supply of electricity until after the expiry of a notice in writing of not less than sixty clear days of his intention to so enhance the rates, given by him to the State Government and to the Board:

Provided further that if the rates of supply fixed in pursuance of the recommendations of a rating committee constituted under section 57A are lower than those notified by the licensee under and in accordance with the proceeding proviso, the licensee shall refund to the consumers the excess amount recovered by him from them.

II. (1) If the clear profit of a licensee in any year of account is in excess of the amount of reasonable return, one-third of such excess, not exceeding five per cent. of the amount of reasonable return, shall be at the disposal of the undertaking. Of the balance of the excess, one-half shall be appropriated to a reserve which shall be called the Tariffs and Dividends Control Reserve and the remaining half shall either be distributed in the form of a proportional rebate on the amounts collected from the sale of electricity and metre rentals or carried forward in the accounts of the licensee for distribution to the consumers in future, in such manner as the State Government may direct.

(2) The Tariffs and Dividends Control Reserve shall be available for disposal by the licensee only to the extent by which the clear profit is less than the reasonable return in any year of account.

(3) On the purchase of the undertaking under the terms of its licence any balance remaining in the Tariffs and Dividends Control Reserve shall be handed over to the purchaser and maintained as such Tariffs and Dividends Control Reserve.

III. There shall be created from existing reserves or from the revenues of the undertaking a reserve to be called "Contingencies Reserve."

IV. (1) The licensee shall appropriate to Contingencies Reserve from the revenues of each year of account a sum not less than one-quarter of one *per centum* and not more than one-half of one *per centum* of the original cost of fixed assets, provided that if the said reserve exceeds, or would by such appropriation, be caused to exceed, five *per centum* of the original cost of fixed assets, no appropriation shall be made which would have the effect of increasing the reserve beyond the said maximum.

(2) The amount of the Contingencies Reserve shall be invested in securities authorised under the Indian Trusts Act, 1882.

V. (1) The Contingencies Reserve shall not be drawn upon during the currency of the licence except to meet such charges as the State Government may approve as being—

(*a*) expenses or loss of profits arising out of accidents, strikes or circumstances which the management could not have prevented

(*b*) expenses on replacement or removal of plant or works other than expenses requisite for normal maintenance or renewal;

(*c*) compensation payable under any law for the time being in force and for which no other provision is made.

(2) On the purchase of the undertaking, the balance remaining in the Contingencies Reserve shall be handed over to the purchaser and maintained as such Contingencies Reserve.

VA. (1) There shall be created a reserve to be called the Development Reserve to which shall be appropriated in respect of each accounting year a sum equal to the amount of income-tax and super-tax calculated at rates applicable during the assessment year for which the accounting year of the licensee is the previous year, on the amount of development rebate to which the licensee is entitled for the accounting year under clause (*vi*) (*b*) of sub-section (2) of section 10 of the Indian Income-tax Act, 1922:

Provided that if in any accounting year, the clear profit excluding the special appropriation to be made under item (*va*) of clause (*c*) of sub-paragraph (2) of pragraph XVII together with the accumulations, if any, in the Tariffs and Dividends Control Reserve less the sum calculated as aforesaid falls short of the reasonable return, the sum to be appropriated to the Development Reserve in respect of such accounting year shall be reduced by the amount of the shortfall.

(2) Any sum to be appropriated towards the Development Reserve in respect of any accounting year under sub-paragraph (1), may be appropriated in annual instalments spread over a period not exceeding five years from the commencement of that accounting year.

(3) The Development Reserve shall be available only for investment in the business of electricity supply of the undertaking.

(4) On the purchase of the undertaking, the Development Reserve shall be handed over to the purchaser and maintained as such Development Reserve.

VI. (1) There shall be allowed in each year in respect of depreciation of fixed assets employed in the business of electricity supply such an amount as would, if set aside annually throughout the prescribed period and accumulated at compound interest at 4 *per centum per annum*, produced by the end of the prescribed period an amount equal to 90 per cent. of the original cost of the asset after taking into account the sums already written off or set aside in the books of the undertaking. Annual interest on the accumulated balance will be allowed as an expense from revenue as well as the annual incremental deposit:

Provided that, within 3 months from the date upon which these principles are enacted, a licensee may elect to adopt the straight-line method of depreciation accounting in lieu of the compound interest method above prescribed. Straight-line method of depreciation accounting means the method whereby an allowance is made in each year in respect of depreciation of fixed assets employed in the business of such an amount as is

arrived at by dividing ninety per cent. of the original cost of the asset by the prescribed period in respect of such asset.

(2) The year in which any asset becomes available for use in the business and the relative cost thereof shall, in the absence of satisfactory record, be determined by the State Government. All sums credited to depreciation account shall be invested only in the business of electricity supply of the undertaking or where it is not practicable to so invest them in investments approved by the State Government.

(3) Any sums invested in investments approved by the State Government under sub-paragraph (2) shall, as soon as practicable, be utilised in the business of electricity supply of the undertaking and if such sums are not so utilised they shall not form part of the capital base under clause (*d*) of sub-paragraph (1) of paragraph XVII.

VII. (1) Where any fixed asset ceases to be available for use through obsolescence, inadequacy, superfluity or for any other reason, it shall be described in the books of the licensee as no longer in use and no further depreciation in respect thereof shall be allowed as a charge against revenue.

(2) The written down cost of such fixed asset shall be charged against the Contingencies Reserve:

Provided that where the accumulations in the Contingencies Reserve are not sufficient to permit the charging of the entire written down cost of the asset, the excess amount may, be included in the capital base for the purpose of clause (*a*) of sub-paragraph (1) of paragraph XVII.

(3) The amount for which any such fixed asset is sold or the amount of its scrap value when actually realised shall be credited to the Contingencies Reserve.

VIII. When any asset has been written down in the books of the undertaking to 10 per cent. or less of its original cost, no further depreciation shall be allowed in respect of that asset.

IX. When any fixed asset is sold for an amount exceeding its written down cost the excess after deducting all taxes payable thereon shall be credited to the Contingencies Reserve.

X. Except with the previous consent of the State Government, no sums shall be carried forward to a reserve and no dividends in excess of 3 per cent. shall be paid on share capital and no other distribution of profits shall be made to the shareholders in respect of any year of account so long as any of the following sums remain to be written off in the books of the undertaking, namely:—

(*i*) normal depreciation due for that year of account calculated in accordance with the provisions of paragraph VI;

(*ii*) equated instalment in respect of arrears of depreciation, computed in accordance with the provisions of paragraph XI, for that year of account;

(*iii*) arrears, if any, in respect of normal depreciation referred to in

clause (*i*), accumulated after the date of application of the provisions of the Sixth Schedule to the licensee;

(*iv*) arrears, if any, in respect of equated instalments referred to in clause (*ii*).

XI. Arrears of depreciation calculated in accordance with paragraph VI may be written off by equated payments over the remainder of the prescribed period and the amount so set aside in the books of the undertaking may be taken into account in any year as a special appropriation for purposes of assessing the clear profit.

XII. Where contributions are made by consumers towards the cost of construction of service lines constructed after the date on which this Act comes into force only the net cost of such service lines after deducting such contributions shall be included in the cost of fixed assets for the purposes of arriving at the capital base:

Provided that for the purposes of depreciation under paragraph VI, the total original cost of construction of the service lines shall be taken into account.

XIII. (1) Subject to the provisions of sub-paragraph (2) the ordinary remuneration of a managing agent excluding the office allowance mentioned in sub-paragraph (3) but including purchasing commission, if any, shall be based on a percentage of net profits as determined in accordance with the provisions of section 349 of the Companies Act, 1956, and shall not exceed—

(*a*) in respect of the first Rs. 5 lakhs of such net profits—10 per cent; and

(*b*) in respect of all net profits in excess of Rs. 5 lakhs—7 per cent.

(2) The amount paid to a managing agent shall be subject to a minimum payment on account of ordinary remuneration not exceeding two rupees per annum for each complete thousand rupees of paid-up share and debenture capital, provided that for purposes of computing the minimum payment should the share and debenture capital be less than rupees five lakhs it shall be taken as rupees five lakhs and should the said capital be greater than rupees one crore it shall be taken as rupees one crore.

(3) An office allowance drawn by a managing agent which shall include the salaries and wages of all persons employed in the office of the managing agent, but not the salaries of the engineering staff employed for purposes of the undertaking, shall be a percentage of the operating expenditure and the expenditure during the year of account on capital works. The office allowance so drawn shall not exceed—

(*a*) In respect of the first Rs. 1 lakh of operating expenditure—8 per cent.

In respect of the next Rs. 2 lakhs of operating expenditure—5 per cent.

In respect of the next Rs. 7 lakhs of operating expenditure—2½ per cent.

In respect of all operating expenditure in excess of Rs. 10 lakhs—1½ per cent; and

(*b*) In respect of the first Rs. 1 lakh of capital expenditure incurred during the year of account—4 per cent.

In respect of the next Rs. 2 lakhs of capital expenditure incurred during the year of account—3 per cent.

In respect of the next Rs. 7 lakhs of capital expenditure incurred during the year of account—1½ per cent.

In respect of all capital expenditure in excess of Rs. 10 lakhs incurred during the year of account—1 per cent.

Operating expenditure for the purposes of sub-paragraph (3) (*a*) above shall mean the sum of the items of expenditure as defined in sub-paragraph (2) (*b*) of paragraph XVII with the omission of those under clauses (*i*), (*iv*), (*ix*) and (*x*) thereof.

Explanation.—For the purposes of this paragraph, the expression "managing agent" shall include every person, by whatever name called, who is in charge of the management of the whole, or substantially the whole, of the undertaking and where more persons than one are placed in charge of the management of the whole, or substantially the whole, of the undertaking, the total remuneration payable to all such persons shall not in the aggregate exceed the limits specified in this paragraph.

XIV. The Board of Directors of an undertaking shall not contain more than ten directors.

XV. (1) Where at any time within three years before the next option of purchase under the licence arises, the licensee proposes to make any capital expenditure which exceeds twenty-five thousand rupees or two *per centum* of the capital base, whichever is more, in respect of which any amount would in the event of purchase under the option be payable by the purchaser to the licensee, the licensee shall, before giving effect to such proposal, apply to the Board or where no Board is constituted, the State Government for its concurrence.

(2) If the Board or the State Government, as the case may be, does not within one month from the receipt of such application, consent to such expenditure, the licensee may refer the matter to the arbitration of the Authority.

XVI. Any dispute or difference as to the interpretation or any matter arising out of the provisions of this Schedule shall be referred to the arbitration of the Authority:

Provided that where a rating committee has been constituted under section 57A, no such dispute or difference shall be referred to the arbitration of the Authority during the period between the date of the constitution of such committee and the date of the order of the State Government made on the recommendations of the committee.

DEFINITIONS

XVII. For the purposes of this Schedule—

(1) "Capital base" means the sum of—

(*a*) the original cost of fixed assets available for use and necessary for the purpose of the undertaking subject to the provisions of paragraph XII in respect of service lines, and the excess amount referred to in the proviso to sub-paragraph (2) of paragraph VII in respect of any fixed asset which has ceased to be available for use;
(*b*) the cost of intangible assets;
(*c*) the original cost of works in progress;
(*d*) the amount of investments compulsorily made under paragraph IV of this Schedule together with the amount of such investments made after the commencement of this Act from contributions towards depreciation as in the opinion of the Authority could not be utilised for the purpose of the business of electricity supply of the undertaking;
(*e*) an amount on account of working capital equal to the sum of—

(*i*) one-twelfth of the sum of the book cost of stores, materials and supplies including fuel on hand at the end of each month of the year of account;
(*ii*) one-twelfth of the sum of cash and bank balances and call and short-term deposits at the end of each month of the year of account, not exceeding in the aggregate an amount equal to one-quarter of the expenditure under sub-paragraph (2)(*b*) of this paragraph excluding clauses (*i*), (*iv*) and (x);

less—

(*i*) the amounts written off or set aside on account of depreciation of fixed assets and amounts written off in respect of intangible assets in the books of the undertaking before or after the commencement of this Act;
(*ii*) the amount of any loans advanced by the Board;
(*iii*) the amount of security deposits of consumers held in cash;
(*iv*) the amount standing to the credit of the Tariffs and Dividends Control Reserve;
(*v*) the amount set apart for the Development Reserve;
(*vi*) the amount carried forward in the accounts of the licensee for distribution to the consumers under paragraph II.

(2) "Clear profit" means—
the difference between the amount of income and the sum of expenditure *plus* specific appropriations, made up in each case as follows:—

(*a*) income derived from—

(*i*) gross receipts from sale of energy, less discount applicable thereby;
(*ii*) rental of meters and other apparatus hired to consumers;
(*iii*) sale and repair of lamps and apparatus;
(*iv*) rents, less outgoings not otherwise provided for;
(*v*) transfer fees;
(*vi*) investments, fixed and call deposits, and bank balances;
(*vii*) other general receipts accountable in the assessment of Indian Income-tax and arising from and ancillary or incidental to the business of electricity supply.

(*b*) expenditure properly incurred on—

(*i*) generation and purchase of energy;
(*ii*) distribution and sale of energy;
(*iii*) rents, rates and taxes, other than all taxes on income and profits;
(*iv*) interest on loans advanced by the Board;
(*v*) interest on security deposits;
(*vi*) legal charges;
(*vii*) bad debts;
(*viii*) auditors' fees;
(*ix*) management including managing agents' remuneration as provided for in para XIII;
(*x*) depreciation, computed as herein before set out;
(*xi*) other expenses (excluding interest on debentures and loans), admissible under the law for the time being in force in the assessment of Indian Income-tax and arising from and ancillary or incidental to the business of electricity supply;
(*xii*) contributions to Provident Fund, staff pension, gratuity and apprentice and other training schemes;
(*xiii*) bonus paid to the employees of the undertaking—

(1) where any dispute regarding such bonus has been referred to any tribunal or other authority under any law for the time being in force relating to industrial or labour disputes, in accordance with the decision of such tribunal or authority;
(2) in any other case, with the approval of the State Government;
(3) special appropriation sufficient to cover—

(*i*) previous losses (that is to say excess of expenditure over income) which have arisen from the business of electricity supply to the extent in any year permitted by the State Government;
(*ii*) all taxes on income and profits;
(*iii*) instalments of written down amounts in respect of intangible assets and new capital issue expenses to the

extent in any year actually appropriated for the purpose in the books of the undertaking; provided that the amounts so appropriated shall not exceed the amount found by dividing the written down cost of such assets by the number of complete years remaining before the next option of purchase under the licence arises;

(*iv*) contributions to the Contingency Reserve, computed as herein before set out;

(*v*) contributions towards arrears of depreciation;

(*va*) contributions to the Development Reserve referred to in paragraph VA;

(*vi*) other special appropriations permitted by the State Government.

(3) "Debenture capital" means—

capital raised against debentures or other instruments creating a charge or lien on the assets of the undertaking.

(4) "Intangible assets" means—

underwriter's commission and such preliminary and promotional expenditure shown as a debit in the capital account of the undertaking, as has fairly arisen in promoting the business of electricity supply excluding any amount paid on account of goodwill.

(5) "Ordinary capital" means—

in the case of a company, the amount of ordinary capital paid up and attribute to the undertaking of the licensee;

in other cases the net amount standing to the credit of the proprietor or proprietors' account or accounts whether in capital, personal or any other account howsoever called and properly attributable to the business of electricity supply;

(6) "Original cost" means in respect of any asset the sum of—

(*a*) the cost of the asset to the licensee, including the cost of delivery and all charges properly incurred in erecting and bringing the asset into beneficial use,

(*b*) interest charges on capital expenditure incurred, during the period between the date of the grant of the licence and the date when the undertaking commences supply, from borrowed money and properly attributable to the asset, accrued up to the date of such commencement of supply at a rate not exceeding the average Reserve Bank rate ruling at that time *plus* one *per centum*,

(*c*) a proper addition on account of supervision not exceeding fifteen *per centum* of the cost referred to in sub-paragraph (a),

so however that the original cost of any asset shall not in any case exceed the original cost attributed thereto in the books of the undertaking.

(7) "Preference capital" means—
the amount of paid-up capital attributable to the undertaking of the licensee issued on such preferred terms as are sufficient to qualify it for such description.

(8) "Prescribed period" means—
in respect of each of the assets specified in the table appended to the Seventh Schedule, the number of years or period specified therein in relation to such asset, running in each case from the beginning of the year of account next following that in which the particular asset became available for use in the business:

Provided that, on the application of the licensee, the State Government may vary the prescribed period in respect of any assets in use on the date when this Schedule comes into force if, having regard to the physical condition of such assets the application of the table to such assets would be unreasonable. Any question arising out of the decision of the State Government on any such application shall be referred to the Authority for arbitration.

(9) "Reasonable return" means—
in respect of any year of account, the sum of the following:—

(*a*) the amount found by applying the standard rate to the capital base at the end of that year;
(*b*) the income derived from investments other than those included in the capital base under the provisions of clause (*d*) of sub-paragraph (1);
(*c*) an amount equal to one-half of one *per centum* on any loans advanced by the Board;
(*d*) an amount equal to one-half of one *per centum* on the accumulations in the Development Reserve created under paragraph VA of this Schedule.

(10) "Standard rate" in respect of any year of account means the Reserve Bank rate ruling at the beginning of that year, *plus* two *per centum*.

(11) "Written down cost" means—
original cost less the amounts set aside or written off on account of depreciation in the books of the undertaking.

It is not possible to deal with the Sixth Schedule, in detail, within the scope of this chapter, however, some of the important points are discussed below.

Paragraph I of the Sixth Schedule provides that the licensee must adjust his rates for the sale of electricity, whether by enhancing or reducing them, so that his clear profit in any year of account shall not, as far as possible exceed the amount of reason-

able return. However, the licensee will not be deemed to have failed so to adjust his rates if the clear profit has not exceeded the amount of reasonable return by fifteen *per centum* of the amount of reasonable return.

Under Section 57A, power is given to the Board or where there is no Board, to the State Government to constitute a rating committee to examine the licensee's charges for the supply of electricity and to make recommendations in that behalf to the State Government. If the rates fixed by the rating committee are lower than those notified by the licensee, the licensee is bound to refund to the consumers, the excess amount recovered by him from them.

If in any year the clear profit of a licensee is in excess of the amount of reasonable return, the excess should be dealt with as under:—

1. One-third of such excess, not exceeding five per cent. of the amount of reasonable return, shall be at the disposal of the undertaking.
2. Of the balance of the excess, one-half shall be appropriated to a reserve which shall be called the Tariffs and Dividends Control Reserve. The Tariffs and Dividends Control Reserve shall be available for disposal by the licensee only to the extent by which the clear profit is less than the reasonable return in any year of account.
3. The remaining half shall either be distributed in the form of a proportional rebate on the amounts collected from the sale of electricity and meter rentals or carried forward in the accounts of the licensee for distribution to the consumers in future, in such manner as the State Government may direct.

The rules for computation of "reasonable return", "capital base", "clear profit", etc., are given in paragraph XVII of the Sixth Schedule.

Under paragraph IV the licensee is required to appropriate to Contingencies Reserve, from the revenues of each year, a sum not less than one-quarter of one *per centum* and not more than one-half of one *per centum* of the original cost of fixed assets. However, if the said reserve exceeds or would exceed by reason

of such appropriation, five *per centum* of the original cost of fixed assets, no appropriation should be made which will have the effect of increasing the reserve beyond the said maximum. The amount of the Contingencies Reserve is required to be invested in securities authorised under the Indian Trusts Act, 1882.

The Contingencies Reserve cannot be drawn upon during the currency of the licence except to meet such charges as the State Government may approve as being—

(*a*) expenses or loss of profits arising out of accidents, strikes or circumstances which the management could not have prevented;
(*b*) expenses on replacement or removal of plant or works other than expenses requisite for normal maintenance or renewal;
(*c*) compensation payable under any law for the time being in force and for which no other provision is made.

Under paragraph VA the licensee should create a reserve to be called the Development Reserve, by appropriating each year an amount equal to the relief in income-tax and super-tax on the development rebate to which the assessee is entitled to under the Income Tax Act.

The Development Reserve may be appropriated in annual instalments over a period not exceeding five years from the commencement of the relevant accounting year. The Development Reserve is available only for investment in the business of electricity supply of the undertaking.

On the purchase of the undertaking, the Tariffs and Dividends Control Reserve, Contingencies Reserve and the Development Reserve should be handed over to the purchaser, who should maintain the same as such reserves, respectively.

The method of providing for depreciation is prescribed under the Sixth Schedule and the licensee is given an option to adopt straight line method of depreciation in the manner provided.

The amount to the credit of depreciation account must be invested only in the business of electricity supply of the undertaking or where it is not practicable to so invest, in the investments approved by the State Government.

In respect of any year of account, so long as any of the follow-

ing sums remain to be written off, in the books of the undertaking, namely:—

(*i*) normal depreciation due for that year of account calculated in accordance with the provisions of paragraph VI;
(*ii*) equated instalment in respect of arrears of depreciation, computed in accordance with the provisions of paragraph XI, for that year of account;
(*iii*) arrears, if any, in respect of normal depreciation referred to in clause (i), accumulated after the date of application of the provisions of the Sixth Schedule to the licensee;
(*iv*) arrears, if any, in respect of equated instalments referred to in clause (ii);

without the previous consent of the State Government:

(*a*) no sums may be carried forward to a reserve;
(*b*) no dividends in excess of three per cent. may be paid on share capital; and
(*c*) no other distribution of profits may be made to the shareholders.

In addition to the requirements as to accounts contained in the Indian Electricity Act, 1910 and the Electricity (Supply) Act, 1948, the following are the special matters to which the auditor must give attention:—

(*a*) Examine the internal check in regard to the method of billing the consumers and collection of debts. There should be an effective control on the consumable stores and on the recording and payment of wages.

(*b*) Test check debits in consumers' Ledger with—

(*i*) meter books for consumption of electricity;
(*ii*) register of meters for hire charges;
(*iii*) register of fittings on hire; and
(*iv*) sale of fittings from sales book.

(*c*) Reconcile the Consumers' Ledger balances with total of consumers' accounts.

(*d*) Ascertain that credits given to consumers in respect of allowances are proper and duly authorised and see that provision is made in respect of debts which are considered bad or doubtful.

(*e*) Check agreements with consumers who are supplied electri-

city on special terms and also check contracts with local authorities for public lighting.

(*f*) Test allocations of expenditure between capital and revenue, scrutinise carefully expenditure on repairs and renewals, and see that no capital expenditure is written off to revenue. Capitalisation of any expenditure should be duly certified by the chief engineer.

(*g*) The outstandings on consumers' accounts particularly old outstanding debts should be inquired into.

(*h*) Check salaries of engineers, workmen, office staff etc., and see that they are properly allocated under Generation, Distribution and Management respectively and that such allocation is certified by the Chief Engineer or the Managing Director.

(*i*) Ascertain that the prescribed depreciation is provided for in the accounts.

(*j*) Ascertain that the Statutory Reserves are created as prescribed.

(*k*) See that the dividends do not exceed the prescribed limits.

(*l*) See that the annual accounts are prepared in accordance with Schedule VI, Companies Act, 1956, subject to the provisions of Indian Electricity Act, 1910 and Electricity (Supply) Act. 1948.

§ 6. Estate Agents, Auctioneers, Surveyors, etc.

Where considerable sums are received on behalf of clients, whether from auctions, deposits or otherwise, it is most desirable that a separate clients' banking account should be opened for clients' money. Where, however, such a system is not in force, the auditor should check the credit balances shown in the Clients' Ledger, representing money held on behalf of clients, and ascertain that there is sufficient cash on the general banking account to cover such balances, drawing special attention to the fact if this is not the case.

Care should be taken to see that adequate control is exercised over the collection and recording of rents collected on behalf of clients and over payments made thereout for rates, repairs, etc.

Considerable expenditure is frequently incurred on behalf of clients, both in respect of advertising and otherwise, and it should be seen that there is a proper system in force for passing the in-

voices relating thereto and charging the expenses to the clients. Similar remark apply to disbursements incurred through petty cash on behalf of clients. Where sums have been received from clients for the purpose of incurring such expenditure at the date of the Balance Sheet and the whole or part thereof remains unexpended, it should be seen that such balances are carried forward as liabilities.

A proportion of the charges made to clients for fees and commission should be tested. Where outstanding fees and charges, which have not been debited to the clients, are brought into account, a schedule thereof should be prepared and signed by the partners, but care should be taken to see that no items are included that have not been actually earned, as the majority of the fees and commissions will only be payable in the event of negotiations for selling or letting the properties concerned being successful.

§ 7. Executors' and Trustees' Accounts

An auditor is frequently appointed to audit the first year's accounts of an executor or for the period up to the ascertainment of the residuary estate. In such cases the auditor's first duty will be to examine the will and to note carefully any instructions contained therein, as to the disposition of property, the payment of debts and expenses, the creation of trusts, the distribution of the residue, the investment of money belonging to the estate, and similar matters. He should examine the private books of account, copies of taxation returns, bank statements, and other documents of the deceased, consult bankers, solicitors, stockbrokers, accountants and other persons with whom the deceased had dealings and who might be able to give information as to the deceased's affairs. With the information thus obtained, it should be possible for the auditor to satisfy himself whether all assets and liabilities of the deceased have been included in the Estate Duty Account and accounted for in the executorship accounts.

From this point it would be the auditor's concern to verify all the executor's dealings. The sale of investments should be verified by reference to brokers' sold notes and the sale of property with accounts of solicitors, auctioneers and other agents. In this connection the auditor should take care to ascertain that no assets of the estate have been purchased by the executor himself and that

the executor has made no secret profit in dealing with the assets.

The auditor should verify the payment of estate duty by reference to probate of the will, Estate Duty Account and receipt for payment of Estate Duty, legacies with the paid cheques or receipts therefor and all other payments with the usual vouchers. It should be seen that provision is made for all outstanding and accrued expenditure.

All rents, interest and dividends received should be verified by examination of counterfoil receipts given for rents and counterfoils of dividend and interest warrants and it should be seen that proper apportionment of all such receipts has been made. Where the residue of the estate has been settled on persons in succession, the auditor should ascertain that apportionment of all relevant receipts and payments in accordance with the appropriate rules has been made, and where no power to retain or postpone conversion of unauthorised investments is given, that all such investments have been converted into cash and the proceeds invested in authorised securities.

In so far as the estate has not been fully distributed, the auditor should verify the assets held in the usual way, by inspecting the title deeds of property, the certificates for stocks and shares, banker's certificates in respect of bank balances, etc. It should be seen that all investments are in accordance with the terms of the will or statute, and that no devastavit (breach of duty involving loss to the estate) has been committed in respect of capital.

Where trusts are created by a will or by a deed of settlement the testator or settlor may have provided that the trust accounts shall be audited. As stated in Chapter I § 4(D) banking and insurance companies usually insist on this condition before agreeing to act as trustees. The following are the principal matters to which attention should be given by the auditor:

(*a*) Ascertain the precise terms of the trust and see that all conditions have been complied with and that the funds or investments comprising the settlement are fully accounted for.

(*b*) Ascertain that all advances to beneficiaries are in accordance with the terms of the trust and examine appropriate vouchers therefor. Vouch all expenditure incurred on the maintenance

of infant beneficiaries and see that such expenditure is properly authorised.

(*c*) Vouch the receipt of all income in the usual manner.

(*d*) Vouch payments to beneficiaries and disbursements by the trustees and see that any remuneration paid to them is in accordance with the trust instrument.

(*e*) Ensure that all bonus shares receivable, provisional allotment letters for rights to new shares and similar matters arising from the investments held by the trustees have been properly dealt with.

(*f*) Verify in the usual manner all securities, etc., held at the date of the balance sheet and obtain confirmation of bank balances by banker's certificates.

(*g*) Enquire into the reasons for any undue delay in the re-investment of trust funds and, if necessary, draw attention to this matter in his report.

The following is a form of certificate which an auditor should append to the accounts examined by him, subject to any qualification that may be necessary:

> "I certify that the above accounts exhibit a true view of the state of the affairs of the ..... Trust, and that I have had the securities of the trust fund investments produced to me, and that I have verified the same."

§ 8. Hotels

The auditor should enquire carefully into the system of accounts in use, as unless the system is good the opportunities for leakage and manipulation are considerable. The Visitors' Ledger should be examined, and the daily totals vouched into the Summary, and from the Summary into the Impersonal Ledger and Cash Book. It should be seen that items paid out on account of visitors are properly charged up to them, and have been duly collected. The boarding and lodging should be checked with reference to the number of days the rooms were occupied and the extent of vacancies should be looked into.

Proper stock accounts should be kept for wines, spirits, cigars, etc., and the auditor should test the operation of these accounts.

The question of the treatment of depreciation of bedding, linen,

plate, cutlery, china, etc., is important. It is usual either to revalue these items at the date of each Balance Sheet or to capitalise the original expenditure, and create a Provision for Renewals Account, crediting thereto an ample amount according to the experience of previous years, and debiting the actual expenditure on renewals, the balance being carried forward.

Proper provision should be made for the depreciation of furniture and premises, and where the furniture is on the hire-purchase system, the auditor should ascertain that revenue is duly charged with the interest or hire portion of the instalments paid.

In a large hotel there will be several Petty Cash Accounts, and the auditor should arrange for the balances to be verified simultaneously, in order to prevent manipulation.

§ 9. Industrial Concerns

The following are the special points to which the auditor must give attention:

(*a*) Examine the system of internal check in regard to the purchase of raw materials. There should be an adequate control over the purchase and issue of materials and stores. The system of payment for the purchases should be inquired into. Vouch the purchase invoices with particular attention to discounts and allowances. The purchases of the last month should be test checked with the stock records.

(*b*) Inquire into the system of effecting sales and the check on the delivery of finished products. Vouch the sales invoices with particular attention to the sales to associate and related companies and firms. The last month's sales should be test checked with the stock records. Ascertain that sales of by-products and scrap are properly accounted for.

(*c*) Consider the system of internal check in relation to production. The correlation between the consumption of raw material and the production should be examined. The production record should be adequate to account for the raw material consumed, finished products obtained, loss in production, wastages and rejections.

(*d*) Inquire whether there is an adequate control on consumable stores, fuel etc.

(*e*) If the cost of empties used is material in amount, see that there is an adequate system of recording the purchase, consumption, issue and return of empties. If the empties are returnable, adequate depreciation, having regard to their condition, should be written off.

(*f*) See that there is an effective control on the recording and payment of wages. The wages should be vouched with the Wages Book, see that they are properly certified and test check the casts and extensions. See that the wages paid for manufacturing of plant and machinery and tools have been duly capitalised.

(*g*) In cases where the building is constructed or plant and machinery or tools are manufactured by the concern itself, it should be seen that the expenditure in respect of materials, stores, wages, etc., is correctly allocated and capitalised.

(*h*) See that adequate stock records are maintained, check the quantity records of stocks, stores, empties, etc. Inquire into the method of valuation of stock of raw materials, finished products and semi-finished products. Ascertain that work in process is properly valued and brought into account. The method of valuation of stock which is adopted must be consistently followed from year to year. Ascertain whether the physical verification of stock has been properly done by responsible officials.

(*i*) Examine the system of issuing samples and the stock records in respect thereof.

(*j*) Ascertain that the stock in trade is valued after making proper allowances for slow-moving, shop-soiled and defective items.

(*k*) If the concern has undertaken manufacturing for other persons, see that the customers' raw materials and the finished products are separately recorded and not mixed up with the company's own stocks.

(*l*) Inquire into the costing system and ascertain the method adopted for absorption of cost of material, labour and expenses. Also inquire whether the financial records are reconciled with the costing records.

(*m*) Examine the ratio of gross profit to sales and compare the same with that of the previous years and examine in detail

the reasons for increase or decrease in the gross profit. The variations in the major items of expenses must be carefully looked into.

(*n*) Inquire whether the distinction between capital expenditure and revenue expenditure is observed. Test check particularly the expenses on repairs and replacement with a view to ensure that no item of capital expenditure has been written off as a revenue item. There should be a proper sanction for capital expenditure by the Board of Directors.

(*o*) Inquire into the provision for depreciation and see that proper method of depreciation is adopted having regard to the nature of the assets and that the rate of depreciation is adequate. If the machinery is purchased on deferred payment terms, depreciation should be provided on the full cash price thereof. It should be seen that, on uninstalled machinery, depreciation is not provided for. In case a factory has worked extra shifts, provision should be made for depreciation on account of extra shifts. Ascertain that obsolescence write offs are adequate.

(*p*) See that a proper method of write off is adopted in respect of jigs, tools, patents, drawings, trade marks, etc.

(*q*) Ascertain that the liabilities on account of sales tax, excise duties, octroi duties, cess, etc. have been properly taken into account and the refunds due in respect thereof have been adjusted.

(*r*) Ascertain the forward contracts for purchase of raw materials and for sale of finished products. If there are any outstanding forward contracts, the contingent liability, if any, on this account should be properly disclosed.

(*s*) Inquire into the existence of any charges on the fixed and current assets of the concern and see that a proper disclosure thereof is made in the Balance Sheet.

§ 10. Landed Estates

On the occasion of the first audit, the counterparts of the tenants' leases should be examined to ascertain the rentals and terms, and these should be checked with the Rent Roll.

The Rent Roll should be compared with the Terrier, which is a survey of the estate, in order to ascertain that all the properties

comprised are entered on the Rent Roll, except those accounted for as unlet or otherwise.

On subsequent occasions only the counterparts of new leases need be examined.

Rents received should be vouched, and it should be seen that proper authority is forthcoming for deductions or allowances. A schedule of all properties unlet, or those occupied rent free as part of the emoluments or wages of office, or otherwise, should be prepared and submitted to the auditor, certified by the landlord. Arrears should be checked forward from one period to another, and those outstanding any length of time enquired into.

Receipts from sales of produce, stock, timber, game, etc., should be vouched by reference to the counterfoil receipt books or other records. Purchases and sales of properties and expenditure on repairs and improvements should be vouched in the usual manner.

It should be seen that all maintenance and management expenses claims have been properly made for taxation purposes.

§ 11. Newspapers

The auditor should vouch the Advertising Day Book with a marked copy of the publication, making enquiry into any dummy advertisements. Amounts received in respect of advertisements not inserted prior to the date of the Balance Sheet must be carried forward. Similar remarks apply to the vouching and apportionment of periodical subscriptions.

The question of returns in respect of copies unsold is important, and the auditor should see that a proper check is in force relating to this item, and that all returns relating to the period covered by the accounts have been credited to the agents, or provision made for those estimated to be outstanding.

It should be ascertained that all liabilities in respect of contributions and unexpired subscriptions have been included. In some cases, where payments are not regularly made, these may be outstanding for a considerable period. The valuation of blocks and electros should be inquired into, as once they have been used these items are normally of little value. The consumption of newsprints and inks may be counterchecked with the total production.

The cost of starting a newspaper is very heavy and involves considerable outlay in the form of advertising, special discounts for

pushing sales, etc. Such expenditure in excess of the normal may fairly be charged to an Establishment Account, and carried forward. Another method sometimes adopted is to charge all expenditure to Profit and Loss, and to transfer the balance of loss in the early years to an Establishment Account; but this principle is somewhat dangerous, as tending to obscure the true result of working, and should certainly be discontinued immediately the paper is fairly established.

If the paper is ultimately successful, and is able to earn an adequate return on the establishment outlay, the latter may be said to represent goodwill, but it is advisable to write it off out of profits over a period of years.

The auditor should examine the Establishment Account, and satisfy himself as to the manner in which it has been dealt with.

§ 12. Publishers

The audit of a publisher's accounts will vary according to the nature of the transactions. Some publishers do part, if not the whole, of their own printing, and also carry on a wholesale or retail trade in books other than their own, in addition to publishing works. They may also be the proprietors of magazines or reviews. In each instance the questions arising will be those relative to an ordinary trading audit, and need not be referred to here.

Special considerations to which the auditor should direct his attention are the treatment of the value of copyrights, and the amounts for which credit is taken in respect of the Production or Prime Cost Account of each book.

In most cases a separate Production Account is opened for each book, to which are debited the cost of the copyright (if that has been purchased), together with the prime cost of production such as editing, compiling, indexing, setting up type, illustrations, blocks, etc. The cost of paper, machining and binding, is debited to revenue, and stock is taken into account on the basis of this cost.

An analysis of all sales made should be kept in a Stock Ledger, a separate account being opened for each book. This account will be debited with the total number of copies printed, and credited with the number of free copies issued and with the number of

copies sold, the balance thus representing the number of copies in stock.

From an examination of this book it will be possible to ascertain at a glance the way in which the sales of each book are progressing, and valuable information will be thereby afforded as to the manner in which the Production Account should be dealt with. Where a second edition is not contemplated, this account should be written down in the proportion that the actual sales bear to the estimated sales, or the whole edition, where it is expected that this will be disposed of. Where a second edition is contemplated, moulds of the type are usually taken and stereos prepared therefrom, the cost of these items being debited to the Production Account, which will not then be written down so rapidly.

Where such a system as that above described is not in force, but the whole cost of production and printing is charged to revenue, stock and copyrights being value accordingly, these should not be valued above cost, and the auditor should see that where the whole edition is not likely to be sold, the value is reduced accordingly.

Where the publisher does not care to incur the risk involved in publishing a book, it is a common practice for him to accept it at the author's risk, receiving for his services an agreed commission on the sales. In such a case an account will be opened for the book and debited with the total cost by way of production or otherwise. The sales of the book will be analysed from the sales records, and credited to this account. The commission on sales will be debited, and the balance will then represent the sum due to or by the author, any sums received from the author to cover the cost of production having been credited in the first instance. In these cases. the question of copyright and stock values does not arise, and care should be taken to see that no stocks of this nature are included in the general stock.

Where books are sent to booksellers on the sale or return principle, it should be seen that the transactions are properly dealt with in accordance with the principles laid down in Chapter III, § 3.

The auditor should ascertain that provision has been made for all outstanding royalties payable to authors. Where advances have been made on account of royalties, and it is found that the sales

are not likely to prove sufficient to provide the necessary sum, the balance, by custom of trade, is not repayable by the author, and should be written off or provided for.

§ 13. Retail Stores

The following are the special matters to which the auditor must give attention:

(*a*) Consider carefully the system of internal check in regard to cash and credit sales. If customers are given bills to pay at a cash desk, test the duplicates in the assistants' books with the cashier's daily summary. Where cash is taken by the assistants, test the till roll totals with the cash takings or summary books.

(*b*) Enquire into the adequacy of the credit control system. Test the postings to the customers' accounts with the assistants' dockets. Examine a representative number of the customers' sales ledger accounts to ensure that the provision made for bad and doubtful debts is adequate.

(*c*) Consider the system of internal check in relation to purchases. Vouch a representative number of purchases with suppliers' invoices and with stock records, if any.

(*d*) If departmental accounts are kept, test the allocations for overhead charges and purchases.

(*e*) Ascertain the ratio of gross profit to sales of each department and compare the same with that of the previous years and inquire into the variations, if material. Where a pre-determined gross profit policy is followed it would provide an additional check. The ratio of selling expenses to sales provides another useful over-all check.

(*f*) Inquire into the shortages of stocks and make inquiries in regard to unusual variations.

(*g*) Test stock sheets in the usual manner paying particular attention to the values placed upon obsolete lines.

§ 14. Schools, Colleges and Universities

In the case of a school or a college examine the trust deed or the rules and regulations and in the case of a university refer to the Act applicable, rules thereunder and its statutes and regula-

tions. The auditor should note the provisions affecting the accounts and audit.

The auditor should vouch the fees received with the register of pupils, and ascertain that those outstanding will be duly received. Any fees paid in advance in respect of a period subsequent to the date of the Balance Sheet should be carried forward and the fees in arrears should be adjusted. The total fees receivable may in case of doubt be reconciled with the muster rolls.

The auditor should see that extra fees for laboratory, library, examination, games, etc., have been properly charged.

Any freeships or concessions in fees granted should be duly authorised by a competent authority. The hostel fees and deposits received from students should be vouched with the counterfoils of the receipts and the amount outstanding at the date of the Balance Sheet should be agreed with the schedules.

The admission fees should be checked with the register of new entrants.

Where endowments exist, the income arising thereunder should be vouched and it should be seen that the income is applied to the objects of the endowment. If the endowment makes a stipulation as to investments, it should be seen that the same is complied with. The investments should be verified as at the date of the Balance Sheet. Government grants, if any, should be verified.

The auditor should see whether a proper record is kept in respect of furniture, equipment, library books, stationery, sports goods, etc., and whether there is a sufficient internal check thereon and that an inventory is taken at least once a year. Adequate depreciation should be provided and the furniture and other effects which are not serviceable should be written off.

The auditor should vouch the salaries paid to the staff, seeing that increments in salaries are sanctioned by a competent authority. The establishment expenses should be vouched and any unusual expenses, ascertained by comparison with the previous year, should be inquired into.

In regard to investments, the auditor should see that the same are in accordance with the requirements of rules, if any, and that the dividend and interest thereon have been duly collected and that the investments are properly valued for the purposes of inclusion in the Balance Sheet. The investments should be verified by

the auditor. Usually, schools are exempt from income tax and hence refunds should have been claimed in respect of any tax deducted at source. The assets and liabilities should be verified in the usual manner.

The auditor should refer to the minute book of the executive body or the managing committee, as the case may be, for sanction and confirmation of transactions affecting the accounts.

§ 15. Shipping Companies

The auditor should examine the Articles of Association, agreements with managing owners, captains, etc.

The original cost of the ships should be vouched, and only such additions should be made to the cost account as represent proper capital expenditure.

The auditor should examine the instrument of sale for each ship, or part of a ship, owned, and note that a copy of the entry in the register kept at the Port of Registry as indorsed thereon, or obtain a certificate of registry as to ownership, and mortgages outstanding. A mortgage on a ship is effected by means of an instrument in the prescribed form and on the production of such instrument the Registrar of Indian ships at the Port of Registry will record it in the Register Book. The mortgage will be retained by the mortgagee, but its priority dates from the date of production for registry, and not from the date of the instrument.

Voyage accounts are kept in respect of each voyage, and should be vouched by the auditor. It should be seen that each voyage is properly charged with the expenditure on stores. The freight accounts should be vouched with manifests from agents, and advices from receiving offices, and it should be seen that provision is made for outstanding rebates. Passengers' fares, if any, should be vouched, and it should be seen that due allowance is made for return fares outstanding. All outstanding expenses on each voyage account should be provided for before closing the account. The accounts of the home agents and foreign agents should be examined with the vouchers, and it should be seen that foreign exchange is correctly adjusted. The captain's accounts should be examined and vouched in detail, and it should be seen that his remuneration is in accordance with his agreement.

The insurance policies should be examined, and it should be

seen that the premiums are properly apportioned over each voyage, and that returns are claimed from the underwriters where ships have been laid up, or for other reasons. Where the policy is a time policy, the proportion unexpired should be carried forward. It should be seen that the amounts received in respect of claims are properly dealt with. Payments to or by protecting clubs for insurance of extraordinary risks should be vouched in a similar manner.

Charter parties should be examined as to brokerage, commissions, and rates of freight, and it should be seen that agreed returns have been credited to each voyage account.

The auditor should ascertain that proper depreciation is provided and in case an adequate provision for depreciation is not made the auditor should refer to this matter in his report to the members so that they may be aware of the position.

§ 16. Solicitors

The auditor must ascertain that the rules of the relevant High Court, for the time being in force, relating to dealings with clients' moneys and requirements as to maintenance of accounts have been complied with.

When a complete audit is undertaken, apart from the requirements of the High Court Rules, the auditor should deal with the following matters:—

The auditor should examine the provisions of the Partnership Deed particularly those affecting the accounts.

It should be seen that bank accounts are separately maintained for the clients' moneys and the funds of the firm. The total of the clients' balances should be compared, at the end of the year, with the balances of clients' separate bank accounts and if such bank balances are less than the clients' balances, the fact should be mentioned in the report.

The system of dealing with petty cash disbursements should be examined, and it should be ascertained that all disbursements made on account of clients are duly charged up to their accounts. In the case of a large office there may be several petty cash accounts, the balances of which should be counted simultaneously.

In checking the Clients' Ledger, allowances to clients should be vouched, and it should be seen that amounts disallowed on

taxation are properly adjusted. Where disbursements, such as counsel's fees, have been charged to clients, but have not been paid by the solicitor at the date of the Balance Sheet, it should be seen that the liability therefor is included in the accounts.

Credit balances may be found representing moneys paid by clients on account of costs and disbursements which have not yet been debited. If a payment of this nature is wholly on account of disbursements which have not yet been made, the item will in effect be a liability; but where the whole, or a portion, is in respect of costs which have been earned, but which have not yet been debited to the client, owing to the fact that no bill has been rendered, the ledger account should be adjusted by passing an entry through the Bills Delivered Book for the amount received on account of costs, debiting the client's account therewith.

In order to ascertain profits correctly, it is necessary that undelivered costs should be valued, and a schedule should be prepared from the draft bills of costs. The valuation should be made on a conservative basis, provision being made for allowances, whether voluntary or by taxation. All items which are in any way doubtful should be omitted. This schedule should be signed by the partners.

Many solicitors, however, prefer to leave out of account undelivered costs not debited to clients. In such cases it is advisable that a note should appear on the Balance Sheet stating that these items are not brought into account.

In the absence of agreement to the contrary, articled clerks' premiums should be apportioned over the term of the articles.

§ 17. Stockbrokers

The books of a stockbroker are usually balanced each account, or at least once a month. Where a full audit is carried out, the whole of the postings will be checked, the books cast, and the balances checked on the occasion of each account. Owing to the great amount of detail involved, however, this course is seldom adopted, and a partial audit may be carried out, the object of which is to test exhaustively the detail work, and to verify the securities.

In checking the balances on the Clients' Ledgers, it should be seen that sufficient cover is held for all debit personal balances of

importance. Similar remarks apply to the balances on the partners' accounts representing their private dealings. In checking the balances on the jobbers' ledgers, it should be ascertained that they have been properly agreed with the jobbers on the occasion of each account, when it is usual to settle for the balance so agreed. Any balances carried forward for a considerable time, without subsequent dealings, should be enquired into, as they may represent items in dispute. In this connection the Splits Account should be examined. This account is often utilised to adjust small differences, and any items of consequence passed through it should be investigated.

The Tickets Receivable Book should be tested exhaustively by the auditor, who should ascertain that the amount outstanding at the close of each account is subsequently cleared off, and this should be confirmed by reference to the dates of subsequent delivery as shown in the Transfer Delivery Books.

When registered stock is purchased by a broker on behalf of his client, he issues a ticket which is termed a "Ticket Payable." The auditor should test the Tickets Payable Book, and ascertain that the balances outstanding are subsequently cleared off as above indicated.

The General Ledger, which will contain accounts for commission, interest, and expenses, should be checked completely. The commission should be checked from the commission columns of the purchases, sales, and special settlement books, and it should be seen that all half-commissions payable have been duly provided for. The expense accounts should be vouched, and it should be seen that all outstanding liabilities are brought into account.

Commission received on underwriting should be checked with the underwriting book, should one be kept, or with any other evidence available. Stocks of contract stamps should be checked and agreed with the Stamp Accounts. The Dividend Account should be examined and outstanding balances agreed.

The firm's Investment Ledger, representing investments held by the firm, should be checked in detail.

The verification of the securities is the most important and difficult part of the audit. It is sometimes arranged for this to take place several times during the year, without notice being given to the stockbrokers' staff. In this way a considerable moral

check is exercised. In any event the verification must be performed for the purposes of the annual Balance Sheet. The securities will be of four classes:

(1) Securities held by the firm as investments, according to the balances in the Investment Ledger.
(2) Securities held as cover against loans made by the broker, or balances due from clients.
(3) Securities awaiting delivery against Tickets Receivable.
(4) Securities held for safe custody on behalf of clients.

The auditor should attend as soon after the close of the account as possible, in order to avoid the numerous adjustments that become necessary if the examination of the securities is delayed, and dealings therein have taken place. The securities should all be produced at the same time, and should be checked off by the auditor with the Security Book or schedules. The Security Book is a memorandum book, which is made up for each account, showing the total amount and value of securities held, the parties on whose account they are held, and to whom they have been pawned, if at all. If not pawned, they will be in what is called the "Box", *i.e.*, either in the strong room of the firm, or in a box deposited with their bankers. This book will not contain particulars of the securities held for safe custody on behalf of clients, which should be recorded in a separate book. Columns should be provided for the name of the client, the name of the stock, the making-up price, the value, the amount of the client's balance against which the stock is held, and a note made as to whether the stock is in the box, or has been pawned. It must be seen that there is sufficient margin where stock is held as security, the making-up prices and calculations being checked for this purpose, and the clients' balances compared with the ledger accounts. Care must be taken to see that all securities held according to the books are recorded in these schedules, and certificates must be obtained from all banks and other parties to whom stocks have been pawned as cover for loans, stating the amount of the loan and the various stocks held. These certificates will be checked off, and will serve to verify the existence of the stocks mentioned in them. All remaining stocks should be in hand, and be examined by the auditor, the usual precautions being taken to prevent stocks being produced twice.

Securities held for safe custody on behalf of clients will not appear in the financial books. A special memorandum book should be kept to record these securities, but in many cases it is found very difficult to do this, and they are included in the general memoranda books referred to above. In any case, it is impossible for the auditor to prove that all securities held for safe custody are produced to him, and he should be careful to refer to this point in his report.

§ 18. Stockjobbers

The accounts of a stockjobber or dealer, although in many respects similar to those of a broker, differ in some important essentials. The business of a jobber or dealer is to buy and sell as principal, whereas a broker merely buys and sells, as agent for his client, from or to the dealer. Consequently the profit of a broker is obtained from the commission charged by him for his services, whereas the profit of a jobber is derived from selling stock at a higher price than he gave for it, or buying stock at a lower price than that for which he has previously sold it.

The Stock Journal records the dealings in each particular stock for each account, and columns are provided for the quantities of stock dealt in as well as the money values. If the opening balance is a debit, it represents stock in the box at the commencement of the account; if a credit, it is termed "Name-over" or "Box-short," and represents stock which has been over-sold and cannot be delivered. Where the jobber has purchased more stock than he has sold, he is a "Bull" for the balance he holds; where he has sold more stock than he has purchased, he is a "Bear" for the balance. At the close of each account the balance of the quantity columns, whether bull or bear, is inserted at the making-up price, or otherwise, as the case may be, and this should agree the stock quantity columns. The money columns, however, will not usually agree, and the difference will represent profit or loss on the dealings during the account, which should be transferred to a Profit and Loss Book.

The auditor should check the opening and closing balances, both in quantity and value. Postings from the Cash Book for application and allotment money on stocks applied for, underwriting commission, etc., should be checked to the various accounts;

the postings from the jobbers' or brokers' ledgers should be tested; the stock columns cast and agreed, and the profits and losses checked to the Profit and Loss Book. Joint books are frequently kept with other jobbers, the profits or losses being divided by mutual agreement, and the auditor should see that the necessary transfers have been made.

The balances on the Stock Journals should be agreed with the "Bull and Bear" books kept by the partners or their authorised clerks, which are memoranda books recording the dealings from day to day of each stock in quantities and prices only. The auditor should examine these books and ascertain that the bull or bear agrees with the Stock Journals both as to quantity and price, the price being usually marked by the partners for Balance Sheet purposes in the Bull and Bear books. The auditor should also check the calculations of the values of the stocks, as any error in extending the values affects directly the profit or loss.

The Dividend Journal records the dividends receivable or payable. The auditor should ascertain when the various stocks became quoted *ex div.* If the jobber was bull of the stock at that date, the dividend thereon should be ultimately received; if he was bear of the stock, the dividend in respect thereof will be payable by him. If the stock is "even," any dividends received will be payable to other persons, and should be treated as a liability, if not paid over at the date of the Balance Sheet.

The verification of the securities should be carried out in a similar manner to that described in the case of stockbrokers, but the securities to be examined will be all of one nature, namely, those recorded as box balances in the Stock Journals. The schedule of these should, therefore, be checked with the journals as to quantities and verified in the usual manner, certificates being obtained from bankers and others where securities have been pawned for advances. In the case of registered securities, the evidence will take the form of certificates, balance certificates, transfers, transfer receipts, etc., and great care must be exercised by the auditor to ascertain that the total balance of each stock held is duly vouched in one form or another in accordance with the principles set out in Chapter V, §3.

Other points common to the accounts of jobbers and brokers have been dealt with in the preceding section.

§ 19. Theatres and Cinemas

The auditor should ascertain that the system of recording box office takings is satisfactory, and that all cash is paid into the bank at least once every day. The auditor must also satisfy himself that a proper system is in force for controlling advance bookings.

The daily returns from each box office should be signed by the box office official concerned, and entered daily on a final return which should be certified by the treasurer. The final returns should be vouched on to the weekly summaries of income and expenditure which are usually termed Balance Sheets.

The libraries and agents usually settle for seats weekly, and these receipts should be vouched with their returns, which will also disclose any amounts outstanding at the date of the Balance Sheet.

In the case of a cinema the numbers of the tickets issued are automatically recorded on a "clock," and the takings can be tested by reference to the number of tickets at each price registered on the clock as having been issued.

Receipts from the sale of programmes should be vouched to the weekly Balance Sheets from the Programme Book, the amounts being entered after deducting the commission payable to the sellers. Similar remarks apply to vouching receipts from the sale of chocolates, ices, etc.

Receipts from advertising on programmes or on the screen will be vouched with the Advertisement Book and contracts. It should be seen that a proper check is in force relating to the bar receipts. It is usual to charge each bar with supplies at selling price to enable the stock to be checked. The daily summary of takings in each bar should be vouched on to the final daily return, which will be vouched to the weekly Balance Sheet.

A daily summary of the various final returns should be made, representing the amount paid into the bank, and the auditor should examine these with the bank statement, care being taken to see that the dates correspond.

It should be seen that the amounts charged in respect of Cost of Production, or Mounting Account, only represent the actual expenditure on the scenery and dresses, though no objection can be taken to the allocation to this account of salaries, lighting, and other expenses incidental to rehearsals. The auditor should as-

certain that the amount carried forward in the Balance Sheet in respect of this account is not excessive, having regard to the life of the play concerned, and its prospective earning power.

The system adopted for preparing and paying wages should be examined. The wages are usually divided between "front" and "back," the former relating to persons employed in the front of the house, such as box office officials, programme sellers, attendants, etc., while the latter relates to persons employed behind the stage, such as carpenters, scene shifters, mechanicians, etc. The artists' salary list should be vouched with the contracts with the individual artists.

In the case of a cinema, the cost of the films rented, which is frequently based on a percentage of the takings, can be vouched by reference to the renter's invoices and the returns of takings.

Expenditure on advertising should be vouched with the contracts with advertising agents.

Receipts in respect of touring companies should be vouched with the certified returns submitted by the managers of the theatres visited, the percentage of the receipts payable to the touring company being vouched with the contract. Travelling expenses should be vouched with the touring manager's certified schedule. and cartage on scenery with the appropriate vouchers.

§ 20. Trust and Finance Companies

The purchase and sale of investments should be vouched by inspection of brokers' contract notes. It should be ascertained that all dividends and interest receivable have been received, and that all bonus shares, etc., receivable have been properly accounted for. Securities should be verified in the usual manner, and the book value should be compared with the market value at the date of the Balance Sheet. It is not usual to adjust the value of each investment to market price. but to provide, if necessary, for the difference between the total book value and the total market value.

Where shares are not fully paid, the contingent liability in respect of calls not yet made should be stated on the Balance Sheet; but where calls have actually been made, but not yet paid by the company, the amount should be treated as a liability.

The correct treatment of profits and losses made on the sale of investments and of the reduction, if any, in the value of invest-

ments at the date of the Balance Sheet, will depend upon the nature of the company.

In the case of a trust company proper, *i.e.*, a company whose object is to earn income from the ownership of investments, it has been held that its investments are fixed assets, and that, subject to the Articles, the excess of current income over current expenditure can be divided without making good depreciation in the value of the investments (*Verner* v. *General and Commercial Investment Trust, Ltd.*, 1894 2 Ch. 266). Losses on investments sold by such companies need not, therefore, legally be charged to revenue before arriving at profits available for dividend, but similarly profits made must be treated as capital profits.

Each case must, however, be determined having regard to the provisions of Section 205, Companies Act, 1956 and the company's Memorandum and Articles.

In the case of a finance company, whose primary object is not to hold investments for the purpose of earning income, but to buy and sell them at a profit, the investments so held cannot be regarded as fixed assets. They are, in effect, the equivalent of stock-in-trade and must be treated as current assets, and brought into account at their value as at the date of the Balance Sheet. Losses made on the sale of investments must be charged to revenue, or to any Provision for Depreciation of Investments Account that may exist, and profits may be taken to the credit of revenue.

It is sometimes a matter of some difficulty to arrive at a proper value to be placed on shares held in companies which have been promoted by the finance company. The only sound system to adopt is to treat such shares on a cost basis, making the necessary provision if they have depreciated below cost. It is not always possible to rely on market quotations in the case of newly-promoted companies, since such quotations are frequently merely nominal.

Where promotion profits have been received in fully-paid shares, these should not be brought into account at their nominal value. If there is a cash profit on the promotion, apart from the shares, the latter should remain unvalued until realised, when the amount so realised can then be treated as profit. If, on the other hand, there is a cash loss on the Promotion Account, this can be regarded as the cost of the shares acquired, which can be brought

into account at this figure, subject to depreciation.

Where underwriting transactions have been entered into, and the finance company has been obliged to take up shares, the underwriting commission received should be set against the cost of the shares so taken up, and not treated as profit.

Generally speaking, it may be said that the safest method is to credit Profit and Loss Account only with profits actually realised. Where the accounts are not prepared in this manner, but credit is taken for profit represented by shares unsold, the auditor should deal fully with the matter in his report to the members.

The auditor should ascertain what, if any, transactions are open on the Stock Exchange at the date of the Balance Sheet, since shares may have been purchased but not taken up, or sold but not delivered. Where the transactions have been closed subsequent to the Balance Sheet, and the result is a loss, this should be provided for; but no credit should be taken for profit. Where, however, the transactions are still open at the date of the audit, a note should appear on the Balance Sheet, stating that there are contingent liabilities in respect of transactions open on the Stock Exchange, and if the auditor considers the matter important, he should deal with it in his report to the members.

All transactions with associated companies should be carefully examined, and it should be seen that no manipulations are effected for the purpose of "window-dressing" the respective Balance Sheets.

§ 21. Wholesale Traders

The audit of the accounts of wholesale traders will vary according to the transactions. Wholesale trader may be either engaged only in local trade, or in import or export trade, or in a combination of both. The auditor should see that there is an effective check on the recording of sales and purchases and the maintenance of stock records.

The auditor must carefully check that all the sales and purchases are duly supported by vouchers and necessary allowances in respect of return of goods, quality difference, etc., are made. In case of foreign sales and purchases it should be seen that the conversion of foreign currency into rupees is correctly made.

The stock records should be test checked with particular refer-

ence to the last month's purchases, sales and returns. It should be seen that any stock sent on consignment or on sale or return is properly taken into account. The method of valuation of stock should be consistently followed from year to year. In case of a wholesale trader, generally, there will not be any shortages in stock and the opening stock, purchases, sales and closing stock can be easily reconciled, if proper stock records are maintained.

The auditor should carefully examine the rates of trade discount allowed which is particularly important in the case of wholesale traders.

It should be seen that customs duties, clearing charges, godown rent etc., are properly adjusted.

The auditor should see that proper adjustment is made in accounts in respect of liability for sales-tax; refunds of excise duty, import duty etc., and claims on carriers, insurers or Port authorities. In regard to debtors, he must examine the period for which the debts are outstanding, having regard to the usual terms of credit allowed and an adequate provision should be made in respect of bad and doubtful debts, if any.

The auditor should apply the gross profit test and inquire into the reasons for any variations, as compared to the previous year.

CHAPTER XV

INVESTIGATIONS

§ 1. The Nature of Investigations

The term "Investigation" implies an examination of accounts and records for some *special* purpose. It differs from an audit inasmuch as it is not primarily carried out for the purpose of ascertaining whether a Balance Sheet is properly drawn up but rather for the purpose of obtaining information of a particular nature required by a client or, in the case of an investigation of fraud, for the purpose of ascertaining its extent.

The following are the principal classes of investigation met with in practice:

1. On behalf of an individual or a firm proposing to buy a business.
2. For the purpose of perparing a report on profits for insertion in a prospectus.
3. On behalf of an incoming partner.
4. On behalf of a bank for credit purposes.
5. On behalf of a person intending to invest in a private business, a firm, or a company.
6. On behalf of the proprietors of a business where fraud is suspected or known to have taken place.
7. Investigations under Sections 235 and 237 of the Companies Act, 1956.
8. In connection with taxation liabilities.

When an accountant is asked to make an investigation, he should obtain written instructions from his clients as to the exact purpose for which the investigation is required and the period which is to be covered. The accountant is, of course, consulted as an expert and must himself decide, within the limits imposed by his instructions, the extent to which the investigation should be carried, having regard for the information which he considers

will be of importance to his clients and the manner in which his certificate or report will be utilised.

The amount of detail work performed during an investigation is not usually as great as is the case during an audit, although in its application to certain records or transactions it may be much more intensive. It is essential that the investigating accountant should bear in mind throughout the progress of his work the *purpose* of the investigation as this will indicate to him the particular matters to which he must give special attention and the particular viewpoint from which they must be regarded.

Where the books and other records which are the subject of investigation have been properly kept and the annual accounts subjected to a professional audit, the work of the investigating accountant is naturally simplified as he is entitled to assume that the books are arithmetically correct. It must never be overlooked, however, that the investigating accountant's interest in such accounts is different from that of the accountant by whom they were prepared or audited. Thus, where an investigation is being made on behalf of a person proposing to purchase a business, the accounts of past years are examined because they are the only guide to the possible future profits of the business, assuming that the turnover and other similar factors remain unchanged. It might well be, however, that although the accounts are perfectly correct, they contain income or expenditure which if not adjusted would distort any view of future profits which is based thereon.

The investigating accountant should take the greatest care to preserve all his working papers and notes made during the course of the investigation. The working papers should link up the figures shown by the books of the business with the final figures produced by the accountant and should contain adequate notes of all essential interviews. It is imperative that before a report is signed, all schedules are completed as to casts, etc., and essential figures are reconciled. The temptation to submit a report without delay and to leave the "tidying up" of working papers until a later date must be resisted. Irremediable damage could be caused by the inclusion in a report of erroneous statements which have been shown to be incorrect had essential figures been reconciled. Certain types of investigation may give rise to legal actions and the investigating accountant may be called upon to give evidence in civil or

criminal proceedings. In such a case he will find that full working papers are essential.

§ 2. Investigation on behalf of an Individual or a Firm proposing to buy a Business

(A) The Extent of the Investigation

The accountant undertaking such an investigation must bear in mind that a person proposing to purchase a business wishes to obtain as much information about that business as possible, in order that he may form an opinion as to whether or not it is worth buying and, if he decides to buy it, how much he should pay for it.

Where the books have been properly kept and audited, the work of the investigating accountant is simplified but where the accounts have not been audited, it may be necessary for records to be examined much more fully. The client will, undoubtedly, require information not only as to the assets and liabilities at the date of the purchase, but also as to the trend of sales, and the gross and net profits over a number of years, and it will, therefore be necessary to examine the Profit and Loss Accounts as well as the Balance Sheets, and to analyse the accounts for the purpose of comparison.

Where necessary the Trading and Profit and Loss Account for each year should be redrafted on a uniform basis, so that a true comparison may be made between one year and another. When this has been done, the accounts should be set out in columnar form with the addition of a percentage column for each year in which should be entered the percentage to turnover of each item of expenditure. Any material variations in these percentages from year to year will indicate items to which particular attention must be paid, and will also reveal any special expenditure incurred in any year in excess of the normal—as, for instance, in the case of advertising. The Balance Sheets should also be set out in columnar form, and from a comparison of the figures much valuable information may be gleaned which will be of material assistance in the course of the investigation. Having obtained all the information available in this manner, the accountant will be able to decide on the extent of his examination.

In many investigations, where the purchaser is familiar with the type of undertaking and the locality, he is mainly concerned with obtaining reliable information in regard to turnover, since from experience he will know the cost of production and the selling and administrative expenses which are normally incurred. The accountant should prepare a statement of sales, so that a comparison between years and months may be effected. The cause of abnormal fluctuations in turnoever should be enquired into. In arriving at the figure of sales, returns should be deducted as well as trade discount and all allowances, in order to disclose the *effective* net sales. Where the purchaser has no experience of the type of business which he proposes to acquire or is unfamiliar with conditions in the particular locality, he will require, in addition to details of sales, information covering the whole of the Trading and Profit and Loss Account.

In examining the Trading Accounts it should be seen whether the percentages of the various items of expenditure to turnover are constant, or whether they are subject to variation. In this connection, care must be taken when redrafting the Trading Accounts, to set out the items in such a way that the actual cost of each element of expenditure is revealed, and the percentage thereof to turnover calculated. For example, in the case of stores and stocks the closing stock should be deducted from the sum of the opening stock and purchases, thus showing clearly the cost of the stores *actually consumed* or of the *goods actually sold*. It will readily be understood that the percentage of such cost to turnover may remain constant, whilst the percentages of opening and closing stocks and purchases, individually vary. The causes of variations revealed by such percentages *must* be ascertained. They may be due to a rise or fall in the cost of materials manufacturing expenses, sale prices, rates of wages, or to variations in the types of product sold, etc., but the possibility that they are due to errors or inflations in the value of the stocks, fictitious sales or other manipulations of the accounts, must not be overlooked. The stocks at the end of each period should be compared and tested with the stock records, and the accountant should ascertain that the basis of valuation of stock has been uniform throughout. If there is a considerable increase in the value of the stock held, without a corresponding increase in trade or rise in the prices of

materials, this may be due to inflation of values, which may be expected to cause a variation in the percentage of the cost of goods sold.

The detailed stock sheets for each year under review should be examined and a comparison made of the values placed on stocks of similar items year by year. Care should be taken to see whether there is any evidence of obsolete stocks continuing to be included in the stock sheets at their previous values or any other suggestion of over-valuation. All insurance policies relating to stocks should be examined and the values placed on stocks for accounting purposes compared with those for which they have been insured.

The Trading Accounts for the last few financial years, and the records for the period from the date of the last Balance Sheet to the date of the investigation must be examined in greater detail, particularly where the gross profit has increased as compared with former years, as it is possible that, with a view to the sale of the business, manipulations may have been carried out with the object of inflating the profits of these years. This would have the result of disclosing a more prosperous position than was actually the case and, since the price payable for goodwill is usually calculated on the basis of profits or turnoever, it would also have the effect of increasing the purchase consideration. The most usual methods of inflating sales are by—

1. Including goods on sale or return or on consignment as completed sales.
2. Ante-dating invoices relating to the period subsequent to that covered by the accounts.
3. Including fictitious invoices for credit sales or increasing cash sales by payments to the business by the proprietor.

Inflation of gross profit may also be effected by increasing the value of closing stock, or by omitting purchases, wages, or other manufacturing expenses.

It will be necessary, therefore, for the investigating accountant to test the sales with the stock records, the Order Book, the Goods Outwards Book, or such other records as may be available. Where no stock records are kept, or where those in use are inadequate,

the accountant must scrutinise the sales with great care, and should note whether they have fallen since the date of the last Balance Sheet, or the date to which the investigation is being taken. The period following the period under investigation should also be scanned closely for rebates, allowances, returns, etc., which are applicable to the period under investigation, as if fictitious sales have been included in the last year, entries of this character will be necessary to eliminate the fictitious debts thus created.

In order to ascertain whether purchases have been omitted, the Goods Inwards Book should be tested with the Bought Journal or purchase invoices, and such creditors' statements as are available tested exhaustively with the creditors' ledger or schedules of liabilities. Workers' time cards, job cards, national insurance cards, etc., must be tested with the wages records in order to ascertain that all wages have been included in the accounts, and the reasons for any marked decrease in expenditure must be enquired into.

In making an analysis of the sales the accountant should extract all unusual profits resulting, for example, from exceptional contracts, or where it has been found more profitable to re-sell raw material than to use it for the manufacture of goods. If it is considered that such items should be included, it is submitted that the profit thereon should be shown in the Profit and Loss Account, and not in the Trading Account, in order that the rate of gross profit on normal trading operations is not obscured.

In a similar manner it will be necessary to make an analysis of the Profit and Loss Account items. The accountant should investigate any items that show undue variation. The last year and the period following it should be examined in greater detail in order to see that there has been no manipulation to increase the net profit. Vouchers should be seen for all payments made after the close of the period under investigation, to ensure that all outstanding accounts have been provided for during that period. Manipulations may be effected by the omission of outstanding liabilities, by insufficient provision for bad debts or depreciation, by starving the business of necessary expenditure on repairs and renewals, etc., or by paying business liabilities out of private funds. The basis upon which bad debts have been provided for should be ascertained, and the debtors' balances at the close of

the period checked in detail with a view to ascertaining that sufficient provision has been made.

The opening Balance Sheet should be checked. The impersonal ledger should be examined, the postings thereto of all the totals from the subsidiary records should be checked and the cash postings tested. The postings of the nominal account balances should be checked at the end of each year to the Profit and Loss Accounts. As regards vouching, it is not usually considered necessary to vouch the payments, even where no audit has been previously performed. The object of the investigation is to ascertain the profits, and to verify the existence and value of assets, and the accountant is not concerned with the manner in which payments have been made, or whether they can be satisfactorily vouched. It is, however, important that all capital expenditure should be vouched, in order to ascertain that no revenue expenditure has been capitalised and profits thus inflated. The asset accounts should be checked in detail, care being taken to see that all items are properly chargeable to capital, and are not items of expenditure in the form of repairs and renewals, which should have been charged to revenue.

The closing Balance Sheet for the period should be checked in detail. If there has been an independent valuation of the assets, the revised figures should be incorporated, otherwise it should be seen that adequate depreciation has been written off. Any assets which are no longer effective or in general use should be shown separately, and it is often advantageous to show the assets in a Statement of Assets and Liabilities in the same groups and order as those in which the income derived therefrom is shown in the Profit and Loss Statement. Expenditure on advertising which has been carried forward as advertising goodwill should receive careful consideration, and it is suggested that in the majority of cases it should be written off.

The value of the goodwill of the business, unless it has already been agreed, may have to be ascertained. Goodwill is an asset which it is difficult to value precisely, and it is impossible to be dogmatic as to the basis upon which the valuation should be computed; even among accountants there is no settled opinion. There are, however, in most trades, recognised methods of valuing goodwill. In many cases it is customary to take the average profits

for a definite number of past years, multiply such average by an agreed number and regard the result as the value of goodwill. This is expressed as "so many years purchase of an average of so many years." This method is not scientific and will result in a value being placed upon goodwill which may be entirely erroneous when considered in the light of the ratio of the profits earned to the total capital employed in the business.

Another method of arriving at the value of goodwill is to base it upon *super-profits*. These were defined by the late P. D. Leake as "the amount by which revenue, increase in value, or other advantage received exceeds any or all economic expenditure." Economic expenditure is in turn defined as including "any or all current expenses, expired capital outlay on wasting assets (depreciation) other than goodwill, personal remuneration sufficient to secure continued successful management (which may possibly need ability of a high order) and a rate of interest on capital invested which will attract and retain any necessary capital having regard to the degree of risk incidental to the character of the undertaking." The value of goodwill is arrived at by taking the present value of an agreed number of annuities equal to the super-profits. The rate of interest employed in finding the present value of the annuities is the same as that used in arriving at the super-profits. This method suffers from the disadvantages that the rate of interest has to be estimated and the number of annuities agreed.

A third method does away with the difficulty of agreeing on a number of years purchase. Under this method the whole question is regarded from the point of view of the value of the business as an investment. The rate of interest which may fairly be expected from the employment of capital in the business is fixed by reference mainly to the rate which experience shows can be obtained in businesses of a like nature, due regard being had to the risks to be incurred by the capital, and the value of the assets ascertained on the normal basis as a going concern. Taking the profits which it is considered will be maintained and the rate of interest expected, the maximum amount that the purchaser will pay for the business, lock, stock and barrel, is arrived at. The difference between this sum and the net *tangible* assets is the price paid for goodwill.

The connection between the rate of interest, the value of the

assets and the risk lies in the fact that where the value of the tangible assets is large and they are of a realisable nature, they form some security for the capital employed. Where a business has tangible assets of small value, the maintainable profits probably result from goodwill which is not inherent in the assets, and the risk is consequently greater.

Illustration.

The maintainable profits of a business are Rs. 10,000. The purchaser considers that the value of management is Rs. 2,000. The net tangible assets are valued at Rs. 95,000. Goodwill is arrived at as follows:

Maintainable profit	Rs.	10,000
Less: Management remuneration . .	Rs.	2,000
Return on Capital	Rs.	8,000

If the purchaser considers that a fair rate of interest would be 8%, the value of goodwill would be:

Capital required to produce Rs. 8,000 per annum at 8%	Rs.	1,00,000
Less: Tangible assets	Rs.	95,000
Value of Goodwill	Rs.	5,000

This method is strictly one of valuing, not so much the goodwill, as the *business* as a profit earning concern. It will be realised that without the goodwill the value of the fixed assets, shorn of their earning power, would be vastly inferior to the value of the same assets when considered in conjunction with the goodwill. In fact, the goodwill cannot fairly be valued apart from the fixed assets, nor the fixed assets apart from the goodwill. Together they constitute the source of the capacity to earn profits from which their value to the business as a going concern is derived. Strictly, therefore, the fixed assets and the goodwill should be considered as one asset for the purpose of valuation, but where a value is plac-

ed upon the fixed assets, the difference between the total value of the business as a profit earning investment and the value attributed to the tangible assets may be regarded as the value of the goodwill.

(B) THE USUAL ADJUSTMENTS NECESSARY

Assuming that the accountant has investigated the accounts as far as he considers necessary and is of the opinion that they are correct, a considerable number of adjustments will, normally, have to be made to arrive at the profits upon which his report must be based. The object of the report is to afford the purchaser information as to the achievements of the business in the past, from which he may form an opinion as to its probable earning capacity in the future. For this reason, although the report should deal with past facts, it is necessary to adjust the past profits of the business to conform to the conditions that will obtain after the purchase, *i.e.,* to show what the net profits would have been, *based on the same turnoever,* had the conditions of management, finance, etc., been the same in past years as those which will prevail after the purchase.

It will usually be found necessary to add back the following items to profits:

1. Interest on partners' capital and current accounts, and also partners' salaries to the extent that these exceed a fair remuneration for management.
2. Interest on loans and overdrafts (if any), except the interest applicable to loans to be taken over by the purchaser. Otherwise, it is to be assumed that the purchaser will provide sufficient working capital, in which case such charges will not be incurred.
3. Rent, if the purchaser is purchasing the trade premises hitherto rented by the vendor.
4. Discount on purchases, in so far as the business has not been able to take advantage of all discounts owing to lack of working capital.
5. Exceptional losses such as those arising by reason of insufficient insurance, although in such cases the full insurance premium should be charged; costs and damages incurred by

actions-at-law and other losses not arising in the ordinary course of business.

6. Capital losses such as losses on sales of fixed assets or investments.
7. Any additions or improvements of a capital nature that have been charged to Profit and Loss Account.
8. Any excessive provisions for bad debts or other contingencies.
9. Excessive provisions for depreciation.

The following items should be deducted from the profits:

1. Income from assets not being taken over by the purchaser.
2. Rent, if no charge has been made for this in the Profit and Loss Accounts, and the purchaser is not acquiring the trade premises.
3. Exceptional profits, such as compensation for compulsory removal of premises, speculation profits, etc.
4. Capital profits, such as those arising from sales of investments or fixed assets.
5. Adequate Depreciation, where this has not been provided for.
6. A reasonable sum for management remuneration, if none has been charged in the accounts.

The question of depreciation is a most difficult matter to deal with, but it is preferable for the profits to be stated, after providing an adequate amount for depreciation, if this can be arranged. As the values upon which the purchaser will in future base the provision for depreciation will in most cases be different from those adopted by the vendor in the past, it is clear that unless the rates of depreciation are based upon the sale values, the inclusion of charges for depreciation that may have been sufficient in the past will be misleading. In other cases, difficulty may be experienced in arriving at a proper rate of depreciation having regard to the nature of the assets. Where accurate provision cannot be made, the usual charges for depreciation should be added to the profits and the report should state clearly that no provision for depreciation has been made. This matter, in relation to companies, is considered further in § 3 of this Chapter.

(c) THE REPORT

The report should be worded in a clear and unambiguous manner, and must state the precise period covered by the investigation. It should contain all information which may be of assistance to the purchaser, and the accountant should not confine himself only to figures. He should, however, be very careful to avoid any statement which might lead his client to regard his remarks as predictions or estimates for the future. Where the adjustments made are merely of an ordinary nature, it is sometimes thought sufficient to say that all adjustments necessary in the opinion of the accountant have been made, but all adjustments involving special items of importance should be referred to specifically. The report should set out the information which the client requires in sufficient detail to enable him to comprehend the exact position of the undertaking. In order to do this a number of matters which will affect the future will have to be dealt with. For example, where, owing to insufficiency of working capital the business was not able to avail itself of all cash discounts, this should be pointed out, and the effect upon the past profits should be shown. The approximate number of times per annum the capital is turned over should be calculated, as this will vitally affect the amount of working capital required. The business may be fortunate in the possession of an efficient manager, and his willingness to continue in that capacity is an item of information which is of value to an intending purchaser. Where the proprietor has managed the business, but no charge for his services has been made in the accounts, the accountant should make adequate provision for management salaries and state clearly in his report the amount which he has provided therefor. All open contracts which will affect the future of the business, such as agreements to sell goods at a future date at an agreed price, should be set out in full, and it should be indicated whether it would be possible to rescind them if desired. Any necessary provisions in respect of these items should be made.

Reference should also be made to the tenure on which the business premises are held. If the premises are held on a lease, of which only a short term remains unexpired, the question as to whether any difficulty will be experienced in obtaining a renewal of the lease at a reasonable rent may

have a vital bearing upon the desirability or otherwise of acquiring the business.

§ 3. Investigation on behalf of the promoters of a proposed Company

Under the Companies Act, 1956, any prospectus issued by or on behalf of a company or by or on behalf of any person who is. or has been, engaged or interested in the formation of a company, must set out the reports specified in Part II of Schedule II of that Act. (*See* Chapter VIII, §3)

An accountant making an investigation of the accounts of a business proposed to be acquired by a company should remember that he is not only responsible to his clients for the work he performs, but also that he bears no small responsibility towards the public, since, on the faith of his report as an expert the public will be asked to subscribe for shares in the company. It is, therefore, important that the accountant should ascertain as far as he can the *bona fides* of all parties interested in the matter, since in the event of the new company proving unsuccessful and legal proceedings being taken he is likely to find himself involved.

Similar remarks apply to the auditor of a company who is required to sign a report for inclusion in a prospectus.

In the United Kingdom, the prosecution brought in 1950 under what is now Section 12(1), Prevention of Fraud (Investments) Act, 1958 against two of the directors and a partner in the firm of auditors of Richard Crittal & Co., Ltd. is of interest. The accused were charged with making in the prospectus a misleading statement and with having done so recklessly. It was shown that the accountant had delegated to one of his partners the investigation of the matter in question. In the course of his judgment the learned judge said:

"It seems to me a very serious matter for your consideration whether you can possibly say that Mr. Steven, having handed that matter over to his partner, and his partner having in fact made tests and satisfied himself, rightly or wrongly—as we now know, wrongly—but satisfied himself at the time as an honourable man, as an accountant and a careful accountant, that that document was right—can you say that Mr. Steven was reckless in accepting Mr. Morton's (*the partner's*) explanation of that ... —That is the one thing that is said to be against him. There is plenty

of evidence that in other parts he took meticulous care in trying to ascertain whether the books of this company were reliable or whether they were not. But in this particular his evidence is: 'I relied upon Mr. Morton.'"

The accountant and one of the directors were acquitted, but in his judgment the learned judge cast doubts upon the wisdom of appointing a firm as auditors and stated:

"I think it right to say this, that it does call for consideration by the authorities whether this system of appointing a firm of auditors is a satisfactory one...—It may be that this case has shown that it is not very satisfactory, because you do not get what everybody desires—the personal assurance of an individual who is an expert that this is right. It turns out that all you get is, instead of a personal assurance, that that expert, it may be, accepted somebody else's view. It is very difficult to fix responsibility in that case..."

It is difficult to see how the position discussed by the learned judge would be improved by the appointment of individual instead of firms as auditors. It cannot be suggested that a busy practitioner could, or that it would be reasonable that he should, do all the work involved in an audit himself. Sections of the work must be delegated to staff upon whom the accountant is forced to rely. When a firm are appointed auditors it will be the responsibility of one partner to take charge of the case and, in practice, the conduct of the work would have been unaffected had the partner received the personal appointment.

The prosecution brought under the same section in 1954 against the managing director and auditor of Wake and Dean Ltd. (*Regina* v. *Wake and Stone,* Acct., 30th October, 1954), was concerned primarily with the inflated value which had been placed on the company's stock and work-in-progress. In the prospectus issued by the company in 1951 the auditor's report included a statement that the stock and work-in-progress as valued by the company's officials *at the lower of cost or market value* as at 30 June, 1950, amounted to £641,607. It was admitted in court that this figure was "false, deceptive and misleading" in that it was far too high. It was shown that timber had been taken at a flat rate and had been measured in such a way as to include all the air as well as the timber. The stock sheets did not show the manner in which the

figures for work-in-progress and general stocks had been arrived at and the original valuations, amounting to £495,000 (already excessive) had been plainly altered by percentage additions which increased the already inflated value by a further £140,000. Although the auditor asked for an explanation of the alterations he accepted, without any attempt at independent corroboration, the statement of the managing director that they had been made to correct errors in the original valuation.

The managing director, who had pleaded guilty to the charges brought against him, was sentenced to imprisonment. The auditor, who had pleaded not guilty, was convicted on one count, *viz.*, that he had signed the report *recklessly* and was fined £200 (with the alternative of six months imprisonment).

The following remarks made by the learned judge in the course of his direction to the jury are of great interest:

"It is quite impossible . . . to lay down that an auditor is correct and not being careless if he accepts the explanations of a director to any question he may put to him. . . Quite clearly you must look at all the circumstances of the case, and taking into account all the circumstances, say to yourselves: 'Would a reasonably careful auditor and accountant be satisfied with the director's answer or the director's entry in the book, or ought he as a reasonably careful auditor and accountant to have gone further and checked it in some way?' That is really the question. You cannot, of course, lay down strict rules as to what is care and what is not. You must take into account all the circumstances of the case and make up your minds about it. You may, of course, take it that if an auditor neglects to take the reasonable steps that you think he ought to have taken, then he is being careless; but if he is careless, in all the circumstances, to a high degree so as to be deserving of punishment, then you may take it as being reckless."

Before imposing the fine, the judge addressed the following remarks to the auditor:

"You are an auditor and an accountant; one of a professional body of men to whom the public at large is entitled to look for careful and disinterested advice and help and guidance; and you have failed in your duty and you were so excessively careless as to be reckless. I cannot treat that offence as anything but one of considerable gravity. . ."

The Companies Act, 1956, requires the prospectus to disclose the profits or losses of five years, but it is very common for the

accountant to be asked by the promoters to investigate and report upon the profits of a larger number of years.

The object of the investigation is to arrive at the normal trading profits during the period, and the accountant should confine himself to ascertainable facts, and not indulge in calculations or problematical estimates of future operations. The routine to be followed and the points to be borne in mind have already been set out at length in the preceding section, but an investigation with a view to giving a report as to profits for publication in a prospectus is of narrower scope than an investigation on behalf of an intending purchaser. Only those matters directly affecting the figures of normal trading profits for the periods should be examined and reported upon.

As has been indicated in § 2 of this chapter, the accountant will normally find it necessary to make a number of adjustments in the recorded profits or losses, or assets and liabilities, in arriving at the figures to be included in his report. The Companies Act, 1956, requires that the report shall either indicate by way of a note the adjustments as respects the figures of any profits or losses or assets and liabilities dealt with by the report which, appear to the persons making the report, necessary or, alternatively, that the adjustments should be made and the report indicate this fact. The latter alternative is more frequently employed in practice.

One of the most important of the matters which frequently require adjustment is the provision for depreciation of fixed assets. Although fixed assets normally appear in the books at cost, less accumulated provision for depreciation, they are usually valued for prospectus purposes at their current values which, under existing conditions, may be far in excess of cost. In some cases the new values are incorporated in the company's books, but in others the book values remain unaltered, the revised values being used only in the prospectus.

Whichever method is adopted, however, it will be appreciated that:

(*a*) The actual provisions made for depreciation in the years covered by the report will not have been calculated on the enhanced values now placed on the assets concerned;

(*b*) The revised values will probably have been employed by the directors in calculating the assets cover for the issue;

(*c*) The public may be asked to pay for shares a price which has regard for the current values of fixed assets, whereas the profits for the years covered by the report have been arrived at after charging depreciation calculated on original book values.

Intending investors, therefore, might be misled by a valuation of fixed assets calculated on one basis and provisions for depreciation of such assets calculated on a different basis. The taxation aspect has also to be considered. If depreciation allowances for taxation purposes differ materially from the provisions made in the accounts for depreciation the recorded net profits may give a misleading impression of the figures on which taxation will be payable and thus of the balance available for distribution as dividend.

The recommendations of the Council of the Institute of Chartered Accountants in England and Wales on these matters are reproduced in full hereunder.

(1) If material to the presentation of the figures, the amounts charged for deprteciacion in the years under review should be stated in the report.

(2) Where there has been a change (whether of rates or by reason of a valuation) in the basis of depreciation during the period covered by the report, the effect of the change should be indicated in the report if the effect is material and cannot be dealt with appropriately in the adjustments made in arriving at the figures shown in the report.

(3) Where the allowances obtained for taxation purposes differ materially from the corresponding charges made for depreciation in arriving at the profits or losses shown in the report:

(*a*) If the difference is material in relation to the profits or losses shown, the report should indicate the fact and should state the amount of the difference (or give the relevant amounts) for the last year covered by the report or for such other period as may be appropriate;

(*b*) If the allowances obtained are substantially greater than the amounts charged, it is a matter for consideration whether adjustments should be made so as to substitute the amounts of the allowances for the depreciation charged.

(4) Where the amounts chargeable in future for depreciation are materially in excess of the allowances obtainable for taxation purposes (for

example, because the assets include assets on which no allowance for taxation is obtainable, or because of a writing-up of assets on a revaluation, or because of the acquisition of a business on terms that the purchase price of depreciating assets is materially in excess of the amount on which allowances for taxation purposes are available to the purchaser):

(*a*) The report should indicate the extent of the excess of the depreciation chargeable over the taxation allowances obtainable for the year immediately subsequent to the period covered by the report;

(*b*) The report should also indicate that owing to the disallowance for taxation purposes of this excess, the sum required to cover it is the gross amount which after deduction of income tax and profits tax will leave a net amount equal to the excess.

(5) Where a valuation of fixed assets is adopted for the purposes of the books and accounts:

(*a*) It is not normally appropriate or practicable, in a report dealing with a period during which there have been material changes in price levels, to make consequential adjustments in the depreciation provisions for past years;

(*b*) The report should, however, indicate the approximate future annual provision computed on the basis of the valuation and should give a comparison thereof with the actual provision made in arriving at the profit or loss shown in the report for the last year covered thereby.

(6) Where a valuation of fixed assets is used by the directors in the prospectus in order to indicate the assets cover for the issue, but the valuation is not adopted for the purposes of the books and accounts:

(*a*) The report should not include figures based on, or a reference to a valuation in excess of the amounts standing in the books;

(*b*) Before consenting (under Section 40, Companies Act, 1948) to the inclusion of their report in the prospectus, the accountants should either:

(i) Ascertain from the directors that the directors' estimates of future profits available for dividend, as shown in the prospectus, have been arrived at after appropriate deductions have been made for the profits which it will be necessary to retain as reserves (including profits set aside for the redemption of preference shares or debentures) in order to maintain the assets cover indicated in the prospectus: or

(ii) If such deductions have not been made, satisfy themselves that the disclosure is sufficient to show how far the directors have taken this factor into account

(7) In the case of a holding company effect should be given to the foregoing recommendations where either:

(*a*) The cost of its shares in subsidiaries is materially in excess of the amount at which the underlying net assets are carried in their books and a material part of the excess relates to fixed assets which are subject to depreciation; or

(*b*) There is used in the prospectus a valuation of the fixed assets of the subsidiaries which is materially in excess of the amount at which such assets are carried in their books or (in a case where the valuation has been adopted by the subsidiaries for the purposes of their books and accounts) were so carried immediately prior to their adoption of the valuation.

(8) In the foregoing recommendations references to "allowances for taxation purposes" should normally be interpreted as the annual allowances (other than initial allowances, balancing allowances and similar items) obtained for income tax purposes for the fiscal years of which the financial years are the basis years. In some cases, however, it may be more appropriate to apply the allowances for profits tax purposes. The circumstances of companies differ greatly and each case should be examined on its merits. In order to obtain a fair basis of comparison it may, for example, be necessary in some cases to take into account, whether by way of spreading or otherwise, initial and balancing allowances and charges, particularly in respect of assets which have a short effective life or where the aggregate depreciation charges over a long period are being compared with the corresponding aggregate taxation allowances.

(9) The figure relating to profit or losses should be set out in the report in columnar form, accompanied by appropriate definition of the bases on which the figures have been computed. A figure of "average profits" should not be stated.

(10) The report should show for each year the profits (as defined in the report) before charging any United Kingdom taxation on profits. In the absence of exceptional circumstances, the report need not include figures showing excess profits tax, national defence contribution, profits tax, or excess profits levy.

(11) If in any particular case the accountants should consider that there are exceptional circumstances which make it desirable to show the amounts of excess profits tax, national defence contribution, profits tax and excess profits levy, it will be for the accountants to decide whether also to show for each year the profits after deducting those taxes.

(12) Where there are material items of expenditure which are chargeable in arriving at profits but are not allowable for taxation purposes, the report should indicate the amount of such expenditure for the last year covered by the report or for such other period as may be appropriate; and should also indicate that the sum required to cover such expenditure is the gross amount which after deduction of taxation will leave a net amount equal to the expenditure which is not allowed.

(13) The reporting accountants should make such adjustments to the profits or losses as shown by the accounts as they consider appropriate

and the report should state that this has been done. If the amount involved in any adjustment is of special importance in relation to the results disclosed, the nature of the adjustment should be stated. The accountants should consider whether the amount involved in any such adjustmenent should also be stated.

(14) In some cases it may be necessary to consider whether adjustments should be made where there are facts which should have been taken into account in preparing the profit and loss accounts for the various years covered by the report if those facts had been known at the time when the accounts were prepared. These adjustments may often consist of a reallocation, between one year and another, of items such as provisions. Where the correct credit or charge for each year concerned can be ascertained with reasonable accuracy at the date of the report, a reallocation may be appropriate it the amounts are material. In particular:

(*a*) *Contract prices.* Where material amounts of income were provisional in that they were derived from government or other contracts which were subject to cost investigations, or which for other reasons were known at the time of making up the accounts to be liable to subsequent price adjustments, consideration should be given to the question of whether estimates should be adjusted, having regard to the most recent information.

(*b*) *Deferred repairs.* Owing to conditions arising out of the war many businesses have had to defer necessary expenditure on maintenance of their equipment. Where claims have been made for allowances for deferred repairs for excess profits tax purposes, or provisions therefor have been made in the accounts, these should be regarded as *prima facie* evidence of the existence of deferred maintenance at the relevant dates. The accountants should, where necessary, make adjustments to correct under—or over-provisions at previous balance sheet dates.

(c) *Bad or doubtful debts.* Adjustments should not normally be made, in the light of subsequent events, to provisions which were considered to be reasonably necessary in respect of bad or doubtful debts having regard to information available when the accounts of any year were made up. Exceptional cases do arise however where the amounts involved are very material and in such cases it is necessary to consider whether adjustments should be made.

(15) The method of valuing stock-in-trade (whether of raw materials, partly finished stocks) should be reviewed and tested in relation to the fair presentation of the trend of profits. Where it is established that the amount included in the accounts at any particular year end should have been materially different a reallocation should be made. Where during the period covered by the report there has been a material change in the basis on which stock-in-trade was valued and it is not practicable to make an adjustment, because the relevant figures are not ascertainable, there

should be an appropriate reservation in the report. The taxation implications of any matters arising on stock-in-trade also requires consideration. In some businesses, for example constructional engineers or public works contractors engaged on large contracts on which work may be in progress over a lengthy period, some profit element may have been included in the valuation of work in progress. In other businesses no profit element may have been included until the period in which the contract has been completed. The basis on which the valuation has been made should be examined from the standpoint of seeing how far the practice which has prevailed is consistent with that in force at the time of the report and of deciding whether it would be appropriate to make adjustments so as to apportion the profit over the period of the performance of the contract.

(16) It may be undesirable to make an adjustment merely because in the period covered by the report there were items of revenue expenditure which it is blieved will not recur in the future In many businesses special expenditure of one kind or another may be incurred from time to time and it will often be inappropriate to eliminate the particular items which arose in the period covered by the report.

(17) Where a loan of fixed amount is to be repaid out of the proceeds of the issue, or has been repaid out of the proceeds of an issue during the period covered by the report, an adjustment to eliminate or amend the interest charged in each year may be appropriate. If a material adjustment has been made the fact should be stated in the report. In the absence of special circumstances it is inappropriate to make an adjustment for interest where a bank overdraft is to be repaid or reduced out of proceeds of the issue. Where interest charges on loans or overdrafts are of material amount and no adjustment is made, the report should state the facts and, if several years are affected, this may conveniently be done by showing the relevant interest charges in a separate column in the report.

(18) Where in the period covered by the report there were material changes in the nature of the business or the sources of income, or there have been exceptional receipts, the circumstances of each case will require consideration in deciding whether any adjustment be made, but regard should be had to the following general principles:

(*a*) Where another business has been acquired by means of an issue of share or loan capital it may be appropriate to make an adjustment to include the profits of the acquired business in respect of the years prior to acquisition; and for this purpose a suitable method may be to show in a separate column the profits which have been so included. (Where a business is to be acquired out of the proceeds of the new issue, a report on the profits of that business must be given in accordance with paragraph 20 of the Fourth Schedule to the Companies Act, 1948).

(*b*) Where however another business has been acquired out of existing resources, the profits of such business for the years prior to the acqui-

sition should not in general be included, for the reason, amongst others, that for those years the profits of the acquiring business already include profits derived from the use of the resources which were later used to acquire the further business. Similar considerations apply where the acquired business had sustained losses prior to acquisition; but there may be circumstances which require different treatment or appropriate comment in the accountant's report, for example where the further business has a record of material losses and it was acquired towards the end of the period covered by the report.

(c) Where a distinct and material section of the business has been discontinued or sold, it would normally be appropriate to show separately, or to make an adjustment to exclude, the profits attributable to that section of the business where ascertainable. Consideration should however be given to the effect of such adjustments on the trend of results shown by the adjusted profits. If losses have been sustained in the discontinued or sold section of the business and an adjustment is made to exclude those losses, the report should indicate that such an adjustment has been made and state the amounts of the losses so excluded. If no adjustment is made to exclude losses and the discontinuance or sale of the section has had a material effect on the trend of results in the later years, the accountants should refer to the matter in their report.

(d) Considerations similar to those mentioned in (*a*), (*b*) and (*c*) above apply in the case of groups of companies where subsidiaries are acquired or disposed of.

(19) There will be cases where items of expenditure to be incurred in the future have not been borne in the past, or have in the past been materially different in amount. In particular, the charge in future for directors' emoluments may differ materially from that in the past. In view of the length of the period covered by the report and the changes which have occurred in the purchasing power of money, it is usually inappropriate to adjust the past profits or losses. The report should however indicate the facts, for example by way of comparison of the emoluments for the last year covered by the report with what those emoluments would have been under the arrangements in force at the time of making the report.

(20) If the amounts involved are material, management remuneration not covered by directors' emoluments should be dealt with in the manner indicated in the preceding paragraph.

(21) Where an item which has been charged in the accounts has been disallowed for taxation purposes as being capital expenditure, it should not necessarily be adjusted. Moreover no adjustment should be made to write back, as being capital, expenditure which has been charged in the accounts and allowed for taxation purposes, even though some items may be of a kind which might have been regarded as of a capital nature if a different accounting practice had been followed. Where an adjustment is

made, it is necessary to consider whether it has a significant effect on the provisions for depreciation.

(22) Where a material amount of development or similar expenditure is carried forward on the grounds that it is abnormal and has a continuing value to the business, the nature of the expenditure and the manner in which such expenditure has been dealt with in the past or is proposed to be dealt with in the future, together with the reasons for carrying it forward, should be investigated. The treatment in the report will necessarily depend on the circumstances of each case. If necessary, adjustments should be made so as to charge the expenditure against the revenue of the appropriate period. If expenditure is carried forward the report should indicate the nature and amount of the expenditure carried forward at the close of the period covered by the report and, in some cases, should also indicate the period over which it is to be written-off in future years. Adjustment is not usually required for amounts which represent normal annual expenditure on designs and prototypes of the following year's products of companies whose usual practice is to carry forward such expenditure as a charge against the revenue of the following year. Conversely, the accountants should consider whether the trend of results has been affected materially by charging against profits expenditure of abnormal amount which could properly have been carried forward to a period following that in which it was incurred.

(23) Adjustments should be made in respect of any items which affect the profit and loss account but have not been dealt with through that account.

(24) Where in the period covered by the report there has been a material change in the accounting principles applied, or the method of computing profits or losses has in any material respects not been in accordance with accepted accounting principles, the profits or losses should, if practicable, be adjusted so that they are computed in accordance with consistent and accepted principles or, if this cannot be done, the matter should be explained in the report.

(25) The reporting accountants should consider whether a report covering the minimum period required by law, or by a stock exchange, presents a fair view of the trend of results having regard to any exceptional circumstances during that period. It may be necessary to extend the period or make appropriate comments.

(26) The reporting accountants may have knowledge of events subsequent to the end of the last year covered by their report, or of other special circumstances not dealt with in the foregoing recommendations, which in their opinion have had or may have a material bearing on the statement of past profits or losses, or on the context in which that statement appears. In such circumstances the accountants should consider whether the facts should be stated in their report or whether this is rendered unnecessary by the manner in which the matter has been dealt with elsewhere in the prospectus.

(27) The statement of assets and liabilities should be so arranged that

the liabilities are deducted from the assets, ending with the proprietorship interest.

(28) The report should make clear whether an amount has been set aside for future income-tax and, if so, should specify the amount and the basis on which it has been computed.

(29) Where quoted investments are held the report should state the market value on the balance sheet date; and if the amount standing in the books is greater than the market value on that date, the satement of assets and liabilities should include the market value instead of the book amount.

(30) The report should incorporate all notes (such as those relating to market values, commitments, rates of exchange or arrears of dividends on cumulative preference shares) which appeared on the last balance sheet, so far as the notes are material to a proper appreciation of the position at the balance sheet date.

(31) The accountants' report deals with the assets and liabilities at the last balance sheet date and should therefore not include any addition in respect of the expected proceeds of the issue. This can appropriately be dealt with elsewhere in the prospectus.

(32) The reporting accountants may have knowledge of material events subsequent to the last balance sheet date, for example where there has been a material fall in the market value of investments or of stock-in-trade. In such cases and where the reporting accountants have knowledge of any other special circumstances, not dealt with in the foregoing recommendations, which in their opinion have had or may have a material bearing on the statement of assets and liabilities, they should consider whether the facts should be stated in their report or whether this is rendered unnecessary by the manner in which the matter has been dealt with elsewhere in the prospectus.

(33) Where the report involves subsidiaries or branches or overseas businesses the circumstances are not usually such as to be suitable for the application of any general recommendations. For example, where subsidiaries or branches have different accounting dates it may not be practicable or appropriate to apportion the figures of profits or losses so as to obtain aggregates for a common period and the appropriate treatment will be a matter for the accountants to decide in the circumstances of each case. Similarly, where a material part of the profits is derived from overseas branches or companies it will be for the accountants to decide whether it is desirable to show separately the amount of such profits, or of the overseas taxation thereon, or of both, and the manner of indicating the position where there are material exchange restrictions on the transfer of overseas profits. All these matters and many others which arise in relation to groups and overseas businesses require consideration of the circumstances in each case to ensure that the report will not be misunderstood. In all cases where a matter is material the report should state clearly what has been done. The accounts of some subsidiaries or branches may have been audited by accountants other than those who are reporting

for prospectus purposes and it is then necessary for the reporting accountants to consider in the circumstances of each particular case whether they should examine the books and records of the subsidiaries of branches concerned, for which purpose it may be necessary to employ overseas agents. The reporting accountants should consider the desirability of communicating with the other auditors to ascertain whether they wish to draw attention to any matters which may be relevant to the report required for prospectus purposes.

(34) Before consenting (under Section 40, Companies Act, 1948) to the inclusion of their report in the prospectus, the reporting accountants should have regard particularly to:

(*a*) The manner in which the directors, in their statement of estimated current and future profits, deal with figures shown in the accountants' report and with matters to which attention has been drawn in that report. *Note.*—The Share and Loan Department of the Stock Exchange, London, requires the company to furnish the department with an outline of the facts on which the estimated profits is founded.

(*b*) Material facts of which they have knowledge in relation to the directors' estimates.

(*c*) The manner in which any special circumstances have been dealt with in the prospectus, where the accountants have decided that no reference thereto is necessary in their report. (See paragraphs 26 and 32.)

(35) In cases where their report deals with assets and liabilities of a company or business acquired or to be acquired, the reporting accountants should ascertain from the directors that the directors' estimates of future profits available for dividend, as shown in the prospectus, have been arrived at after appropriate deductions have been made in respect of pre-acquisition profits which will not be available to the acquiring company for distribution as dividend.

In view of the fact that a period of at least ten years must be dealt with in the accountant's report, it is most desirable that auditors should recommend to their clients that essential records be preserved for a long period if there is any possibility of a prospectus being required at some future date. The recommendations made on this matter in 1957 by the Council of the Institute of Chartered Accountants in England and Wales are given below.

Accountants' report for prospectus purposes involve the investigation of accounts covering a long period, normally at least ten years. Where the records of the business in respect of the whole of the period have not been preserved such an investigation can be hindered and the reporting

accountants may find it necessary to include reservations in their report. Such reservations may reflect adversely upon the reliability of the figures given in the report. Moreover they may be embarrassing to the company's auditors where they were entirely satisfied, at the time when their audits were conducted, in regard to figures which cannot be verified during the investigation because the records are no longer available.

The Council therefore wishes to emphasise to members of the Institute the desirability of advising that important records should be retained for a long period, particularly where a business is such that there is a possibility that at some future date it may be necessary for a prospectus or similar document to be issued.

The need to retain important records applies particularly to stock inventories, including not only the fair copy summaries but also the rough stock sheets made out at the time when a physical count was taken in the works or storehouse.

When, in the course of his investigation, the accountant ascertains that the company has entered into *exceptional* forward commitments which may affect adversely the position of future profits, he should refer thereto in his report (*Rex* v. *Bishirgian and Others,* 1936, Acct. 28th March, 1936, p. 494 *et seq.*), although it would appear that there is no necessity to refer to *normal* commitments of this nature. In the course of his judgment the Lord Chief Justice said: "the future commitments of a normal business are one thing; the future commitments of a colossal gamble are different, not merely in degree, but in kind . . . the financing, as it is called, is different; the risks are different, and to advertise a business as an ordinary business seeking development, when money is really being asked for to feed and supply an ambitious gamble is simply deceit." This case did not concern the auditors of the company, who were shown to have no knowledge of the excessive commitments, but it is clear therefrom that when a prospectus is issued by a company in such circumstances, the non-disclosure of abnormal future commitments may render the document "a cheat from beginning to end." An auditor who gave a report on profits for inclusion in such a prospectus, *knowing of the non-disclosure,* might find himself involved with the directors in a criminal charge.

The wording of the report should be clear, and the precise periods covered by the investigation should be set out. The profits for *each year* must be set out separately; a statement of average

profits will not satisfy the provisions of the Act, although such a statement may be given by way of additional information.

As has already been pointed out, it is essential that the accountant should retain a complete record of all material information, and of the manner in which he has arrived at the figures he ultimately reports upon, so that he may be in a position to substantiate his report if called upon to do so.

§ 4. Investigation on behalf of an incoming Partner

In addition to the examination which it is necessary to make on behalf of an intending purchaser, the accountant should include in his report to a prospective incoming partner all information which comes to his knowledge that may be of importance to his client in arriving at a decision as to whether he should continue the negotiations. The accountant should obtain a draft copy of the proposed partnership agreement, so that he may be in a position to advise his client as to whether or not the terms thereof appear to be reasonable. Special attention should be paid to the values at which the various assets are to be brought into the new partnership's books, as, if they are over-valued the capitals of the continuing partners will be inflated, and the incoming partner might be prejudiced in the event of a dissolution. If the proposed partnership is to take over the debtors and liabilities of the old partnership, special care must be taken to see that adequate provision has been made in respect of bad debts, or that if bad debts are incurred, the continuing partners will be responsible for them personally. Attention should be paid to the treatment of goodwill, and the amount which the incoming partner is required to pay for his share of this asset.

The accountant should ascertain the reason why the firm wishes to admit a new partner, as this could be due to financial weakness. Should the accountant receive any indication that any of the continuing partners are involved personally in financial difficulties he should report this fact to his client. Section 187 of the Income Tax Act, 1961, provides that, in the event of a change in the constitution of the firm, the assessment should be made on the firm as constituted at the time of making the assessment and when the tax assessed upon a partner cannot be recovered from him it can be recovered from the firm as constituted at the time of mak-

ing an assessment. Hence it is essential that the accountant should inquire into the assessments of the partners and the firm with a view to ascertain whether the incoming partner would be burdened with the tax liability in respect of the income earned when he was not a partner. In case there is any possibility of such a claim arising, the implications thereof must be made clear to the prospective partner.

§ 5. Investigation on behalf of a Bank for purposes of Credit

It is usual for banks, when a loan or overdraft has been asked for, to demad a copy of the customer's latest Balance Sheet, in order to ascertain what assets are available to afford security for the accommodation and the general financial condition of the business.

Sometimes, however, the bank requires more detailed information, and an accountant is called in to carry out an investigation for this purpose. Bankers are interested to know the reason for the required overdraft or loan, as they are careful to see that in such cases the money is usefully employed. Further, they wish to know to what extent the loan is liquid.

The accountant should prepare a statement of assets and liabilities, giving in particular the following information:

1. *Sundry Debtors and Bills Receivable*

Amounts due from:

Trade debtors within the period of credit.
Trade debtors beyond the period of credit.
Partners, directors, officers and employees.
Branches or subsidiaries.
Amount due on bills, divided into short bills and others.
Amount of provision to cover discount and bad and doubtful debts.
Nature and amount of any debts or bills pledged or assigned.

2. *Stock*

Finished stock, stating method of pricing.
Work-in-progress, stating method of pricing.
Raw materials, etc., stating method of pricing.

Amount of stock included above held under trust receipts.
Stock held on consignment, and whether it has been included above.

Amount of stock pledged as collateral for loans or advances.

3. *Real Property, Plant, Buildings, Fixtures and Fittings*

A full description should be given of each item, and the method of valuation clearly shown. Particulars should be given of the method of writing off depreciation, and any recent valuations by an expert valuer should be set out. Full particulars and the amount of all charges on the property, etc., should be detailed.

4. *Investments*

A list should be given of the investments showing the nominal and market values. Where any investments have been pledged as security for loans or advances, full details should be given.

5. *Secured Liabilities*

Details should be given of all debentures and other secured liabilities, showing the amount outstanding, the date repayable, and whether, in the case of debentures, they have been issued as collateral security for an overdraft. Details should also be given of the assets charged, and particulars of the provision made for meeting the amounts due at maturity

6. *Insurance*

A schedule of all insurance policies, stating the risks covered, and the insured amounts and confirming that all premiums due have been paid. It should be borne in mind that where the business is entirely dependent for its existence on assets such as a factory, advances may more easily be secured if a Loss of Profits Policy exists.

The accountant should also examine the Profit and Loss Ac-

count for the last period and, if required, for earlier years in order to ascertain the maintainable profits. The method of doing this has already been dealt with earlier in this Chapter.

The report should state the method of collecting debts, and the period of credit and the terms upon which sales are made. Particulars should be given of all contingent liabilities and especially in respect of the following:

1. Bills discounted.
2. Accommodation bills.
3. Guarantees.
4. Contracts or agreements.
5. Pending law suits and arbitrations.
6. Shares and debentures of subsidiaries where the dividends or interest have been guaranteed.

The accountant should state the reason given for requiring the accommodation and whether in his opinion the amount asked for will be usefully employed and adequate for the purpose for which it is required.

§ 6. Investigation on behalf of a Person intending to Invest in a Private Business, a Firm, or a Company

An investigation for this purpose should cover the same ground as an examination on behalf of a bank for credit purposes, but as an investor does not require his investment to be as liquid as does a banker, greater attention must be given to the maintainable profits and the trend of business.

In the case of a private business or a firm, the accountant should scrutinise carefully the proposed agreement between the investor and the business or firm, and see that its terms are advantageous to his client and that reasonable security is offorded. In most cases of this nature the lender is well acquainted with the character of the proprietors of the business or the members of the firm, but where he is not familiar with them, the accountant should, if he thinks it desirable, inform his client of any facts which render it undesirable for the investment to be made. For example, if there is dissension among the partners of a business, it is possible that the firm may be dissolved in the near future.

In the case of a loan to a company, the Memorandum and

Articles should be scrutinised to see that the loan is within the borrowing powers of the company and of the directors. If it is *ultra vires* the directors, a resolution should be passed by the company in general meeting authorising them to borrow the money. If the money is to be invested in the business on the security of debentures the terms of the issue should be scrutinised carefully, and it should be seen that adequate provision will be made for repayment at maturity. In addition to verifying the existence of any property charged by the debentures, the company's file at the office of the Registrar of Companies should be examined, in order to see that there are no charges entered in the register of charges which are not entered in the company's register of charges.

Where it is proposed that an investment should be made in the preference shares of a private company, which carry the right to a fixed rate of dividend, the price to be paid for such shares will, in the main, be determined by the current level of interest rates. Due allowance must be made, however, for the risk factor and for the non-marketability of the shares. If the shares are redeemable, regard must be had for the date on which such redemption can be effected and the premium, if any, which will be paid by the company. In many cases no date is fixed for the redemption of redeemable preference shares, the terms of issue merely providing that the company has the right to redeem on or after a certain date; in such cases it must be borne in mind that the holder of such shares has no power to insist on their redemption.

If it is proposed that the investment should be in the ordinary shares of a private company, the following factors must be taken into consideration in determining the price to be paid:

(*a*) The extent of the assets "cover" for the ordinary share capital.
(*b*) The amount of profits required for the payment of dividends on shares with preferential rights.
(*c*) The extent of the anticipated future earnings "cover" available to the ordinary shareholders after allowing for (*b*).
(*d*) The current "yield" obtainable on quoted shares of companies engaged in the same industry. This "yield" must be increased to allow for the non-marketability of the shares to be purchased.

(*e*) The restrictions, if any, imposed by the company's Articles of Association on the rate of dividend payable on the ordinary share capital and any other matters which will limit such rate, *e.g.*, amounts agreed to be set aside annually to provide for the redemption of debentures, loans or preference shares.

(*f*) The estimated proportion of future profits which must be left in the business to provide the funds necessary for its expansion.

(*g*) The proportion of the total ordinary share capital which it is proposed to acquire. If a minority interest is to be purchased in a director-controlled company it must be remembered that profits available for dividend may be reduced by increases in directors' emoluments and that, for a variety of reasons, the directors may wish to limit the rate of dividend payable without regard for the interests of the minority.

In all cases the accountant should satisfy himself that the funds to be provided can be usefully employed and, where they are required for a specific purpose, will be adequate for that purpose.

Where an auditor values shares in a company as an expert under the provisions of the company's Articles of Association it would seem that he cannot be called upon to justify his valuation provided that he does not express the reasons which impelled him to his decision. If, however, the auditor offers an explanation of his valuation the court is not precluded from examining such explanation and if it is considered to be incorrect, of upsetting the valuation (*Dean* v. *Prince and Others,* [1953, 3 W.L.R. 271].).

§ 7. Investigation for Fraud

It has been pointed out in Chapter I, § 3, that fraud may be divided into two classes, *viz.*, defalcations involving misappropriations either of money or goods, or the manipulation of accounts, not involving defalcations. The conduct of investigations where fraud is suspected or known to have taken place varies very much according to the circumstances of each case, and it is only possible to consider the matter here in the most general manner.

The fraudulent manipulation of accounts without corresponding defalcations has already been considered from time to time in the

course of this work, and usually takes the form of the inflation of assets, or the omission of liabilities, for the purpose of making the position of a business appear to be better than it really is, or enabling dividends to be paid when profits have not been earned.

Defalcations involving misappropriations of stock vary so much according to the nature of the goods and the trade carried on that it is not practicable to discuss the subject here; but defalcations involving misappropriations of cash present many features in common, and it may be convenient to indicate the general course of procedure where an investigation of this nature is made, taking as an instance the case of a trading business where fraud has been carried out by some individual in charge of the books and cash who has absconded.

Full enquiries should be made as to the authority exercised by the defaulting official and the nature of his duties, as this will give some indication of the opportunities of which he may have taken advantage. Assuming that the official has been in general control of the books and has been subject to little or no supervision, the accountant would be compelled to make a complete investigation from a date arranged with the proprietors of the business.

The cash book should be cast and vouched in detail, and certificates of the opening and closing bank balances obtained from the bank. The cash book should be checked completely with the bank statement, particular attention being paid to the dates when the receipts are paid in, and to ascertaining that each day's receipts have been banked intact.

Where money received from debtors has been misappropriated, it is common to find that, in order to prevent the debtor's account appearing overdue, cash received subsequently from other debtors is placed to the credit of the debtor whose remittance was originally misappropriated, this process being continued indefinitely. This type of fraud is commonly known as 'TEEMING and LADING'. In such cases it may become necessary for the cashier to divide certain remittances in order to obtain the exact amounts necessary for his purpose, and one method of discovering whether this has been done is to examine the original paying-in slips *at the bank*, and to compare them with the counterfoils of the paying-in

book. The slip presented to the bank will contain the correct record of the amount of each cheque, whereas the counterfoil will show any division that may have taken place. This also serves as a check upon the improper manipulation of discounts. All discounts of any consequence appearing in the cash book should be tested, in order to ascertain that they are in order.

Where counterfoil receipt books are used, the counterfoils should be checked with the cash book; and where rough cash books or cash diaries have been kept, these should be compared with the fair cash book.

It should be seen that the proceeds of all bills receivable have been duly received, and bills in hand should be examined.

The best method of verifying the balances due by customers where it is suspected that amounts have been misappropriated, is for the accountant to send out a circular to the debtors, stating the amount of the balance as shown in the books, and asking the debtors to communicate to him direct if they do not agree the amount stated. The permission of the proprietors of the business must of course be obtained to such circularisation and this is often refused as the properietors do not wish it to be generally known that they have been defrauded.

As regards cash payments, special care should be taken, in examining the supporting invoices, to note any that appear to be irregular; and the cancelled cheques should be examined to see that the payees' names agree with those appearing on the invoices. If any vouchers for material amounts are missing, duplicates should be obtained. All amounts charged to the Drawing Accounts of partners or directors should be vouched by them as being correct.

The petty cash book should be vouched and cast. Special attention must be paid to salaries and wages, and the accountant should confirm with a partner or director the existence of all the employees named in the Salaries and Wages Books, and the amounts payable to them.

Where the defaulting party has had access to all the books, it will be necessary for the whole of the postings to be checked, the books cast, and a Trial Balance prepared. In checking the Sales Ledgers special attention should be paid to all allowances and bad debts written off, as entries of this nature may have been made

for the purpose of concealing misappropriations of cash. Similar remarks apply to returns, and where necessary the receipt of the actual goods returned should be traced. In some cases it may be found that the defaulting party has omitted to record sales, so as to be able to appropriate the remittances received without the necessity of falsifying the books further. In order to ascertain whether this has been done, the Order Book should be tested with the day book or copies of sales invoices, to see that all orders that have been executed have been recorded, and reference should also be made to the Goods Outwards Book if one is kept. Where cash sales are made, these should be vouched in detail with whatever evidence may be available, although unless the system employed is a good one, it may be very difficult to ascertain whether irregularities have occurred.

Invoices should be vouched with the Bought Journal if any, in order to ascertain that none has been passed through twice, payment in respect of the original invoice being made to the creditor, but payment for the duplicate being misappropriated by the defaulting party. Duplicates should be obtained of missing invoices, and the creditors' statements compared with the balances as shown by the Bought Ledger or schedule of unpaid accounts. The Goods Inwards Book or the Order Book should be checked with the Bought Journal or purchase invoices to ensure that all invoices relate to *bona fide* purchases.

§ 8. Investigations under the Companies Act, 1956

The Companies Act, 1956, provides for the appointment of inspectors to investigate a company's affairs in certain circumstances.

Section 235 provides that the Central Government may make such an appointment—

(*a*) in the case of a company having a share capital, on the application either of not less than two hundred members or of members holding not less than one-tenth of the total voting power therein;

(*b*) in the case of a company not having a share capital, on the application of not less than one-fifth in number of the persons on the company's register of members;

(*c*) in the case of any company, on a report by the Registrar under Section 234.

Under Section 237, the Central Government must appoint inspectors to investigate a company's affairs if—

(*a*) the company by special resolution, or

(*b*) the Court, by order,

declares that the company's affairs ought to be investigated.

The Central Government may also make such an appointment if it appears to it that there are circumstances suggesting—

(*i*) that the business of the company is being conducted with intent to defraud its creditors, members or any other persons, or otherwise for a fradulent or unlawful purpose, or in a manner oppressive of any of its members, or that the company was formed for any fradulent or unlawful purpose;

(*ii*) that persons concerned in the formation of the company or the management of its affairs have in connection therewith been guilty of fraud, misfeasance or other misconduct towards the company or towards any of its members; or

(*iii*) that the members of the company have not been given all the information with respect to its affairs which they might reasonably expect, including information relating to the calculation of the commission payable to a managing or other director, the managing agent, the secretaries and treasurers, or the manager, of the company.

Inspectors appointed under either of the afore-mentioned sections have power to investigate the affairs of any other body corporate or persons mentioned in Section 239(1) of the Act which, *inter alia,* includes the company's subsidiary or holding company or a subsidiary of its holding company, or a holding company of its subsidiary and any person who is or has at any relevant time been the company's managing agent or secretaries and treasurers or managing director or manager or an associate of such managing agent or secretaries and treasurers.

The inspector has power to examine on oath all *past and present* officers and agents (including bankers, legal advisers and

auditors) of the company and other persons mentioned in Section 240(1) of the Act. If he wishes to examine any person whom he has no power to examine on oath, he may apply to the Court, who may order such persons to attend before it and be examined on oath. If any such officer or agent refuses to produce any book or document or to answer any question put to him the inspector may certify his failure or refusal, whereupon the Court may enquire into the case, and, after hearing witnesses for and against the alleged offender, make an order for the production by him before the inspector of all such books or papers within a date to be specified in the order or require such person to answer any question which may be put to him by the inspector.

The inspector must report to the Central Government, who must forward a copy of the report to the company and also to any body corporate, managing agent, secretaries and treasurers or associate dealt with in the report by virtue of Section 239. Where the inspection is under clause (*a*) or (*b*) of Section 235, a copy of the report must be furnished, on request, to the applicants for investigation.

Where the inspection is under Section 237, a copy of the report must be furnished to the Court.

If the Central Government thinks fit, it may furnish a copy of the report on payment of the prescribed fee to the persons mentioned in clause (*b*) of Section 241(2). The Central Government may also cause the report to be published.

Under Section 242, the Central Government, after considering the inspector's report, may, where it appears that any person has been guilty of an offence for which he is criminally liable, prosecute such persons for the offence.

If it appears to the Central Government that by reason of any such circumstances as are referred to in sub-clause (*i*) or (*ii*) of clause (*b*) of Section 237 (supra), it is expedient to do so, the Central Government may cause to be presented to the Court a petition for the winding up of the company, body corporate, managing agent, secretaries and treasurers or associate on the ground that it is just and equitable that it should be wound up and/or it may make an application to the Court for an order under Section 397 or 398 of the Act.

If, from the report, it appears to the Central Government that

the company or any body corporate, whose affairs have been investigated in pursuance of Section 239, in the public interest, ought to bring proceedings for—

(*a*) the recovery of damages in respect of any fraud, misfeasance or other misconduct in connection with the promotion or formation, or the management of the affairs, of such company or body corporate; or

(*b*) the recovery of any property of such company, or body corporate, which has been misapplied or wrongfully retained;

the Central Government may itself bring proceedings for that purpose in the name of such company or body corporate.

Investigations under Section 237 are usually instituted when it is suspected that the company has been mismanaged or that the directors or officers of the company have been using the company's resources for their own purposes.

The procedure to be followed by the accountant appointed to conduct such an investigation must be determined by the terms of his instructions, but in most cases a very detailed examination of the company's books and records will be necessary. Particular attention must be paid to the verification of the existence of assets, the nature of the liabilities contracted by the company, dealings with subsidiaries, and the manner in which the profits or losses disclosed by the published accounts have been arrived at.

Under Section 247, where it appears to the Central Government that there is good reason so to do, it may appoint one or more inspectors to investigate and report on the membership of any company and other matters relating to the company, for the purpose of determining the true persons who are or have been financially interested in the success or failure, whether real or apparent, of the company; or able to control or materially to influence the policy of the company.

Under Section 240A, the Magistrate of the First Class or the Presidency Magistrate having requisite jurisdiction may on application by the inspector, by order, authorise the inspector—

(*a*) to enter, with such assistance, as may be required, the place or places where such books and papers are kept;

(*b*) to search that place or those places in the manner specified in the order; and

(*c*) to seize books and papers he considers necessary for the purposes of his investigation.

§ 9. Investigations in connection with Taxation Liability

An investigation in connection with tax liability is usually carried out at the request of the client, where he has reason to believe that complete and accurate returns of income for taxation purposes have not been made. Such an investigation may also be undertaken, where the assessments have been re-opened under Section 147 of the Income Tax Act, 1961.

It is not within the province of this work to describe in detail the conduct of such an investigation, nor is it possible to lay down hard-and-fast rules as to the procedure which must be followed. So much must depend upon the nature of the business carried on, the records available, and the opportunities afforded for the falsification of records for the purpose of evading taxation liability. The accountant must bring into play not only a high degree of technical skill, but a wide knowledge of human nature and much ingenuity to arrive at the truth.

After ascertaining the period over which the investigation is to extend, the accountant should first obtain from his client such of the following documents and data as are available:

(1) Books and audited accounts of the business.
(2) Bank pass books or statements, deposit receipts, etc., in the name of the client or his wife or over which either had control at any time during the years under review, and certificates from bankers as to current balances.
(3) Statements of all private assets and liabilities at the beginning and end of the period covered by the investigation.
(4) Schedules of all investments held, showing the dates and cost of purchase and the names and addresses of the persons in whose names they were bought.
(5) Acknowledgments from nominees that they hold assets in their names on behalf of the client.
(6) Bought and solu notes and brokers' accounts in respect of all dealings in investments during the period.
(7) Details of any other non-business assets or property purchased and sold during the period.

(8) Particulars of any legacies, insurance maturities, or other capital receipts during the period.

(9) Particulars of any insurance policies taken out, and receipts for premiums paid thereon during the period.

(10) All interest and dividend counterfoils, and accounts of rents and outgoings of any property held.

(11) Estimates of living and other personal expenses, including cost of children's education, holidays, gifts and other abnormal expenditure.

(12) Copies (if available) of all income tax returns made during the period, and receipts for tax paid.

Where books have been kept and accounts prepared, the investigation will follow the lines discussed in § 2 of this Chapter, special attention being paid to the possibility of sales being omitted, purchases and expenses being inflated, and stock being improperly valued with the object of reducing the profit disclosed by the accounts. The pass books or statements of all personal bank accounts kept must be obtained and analysed in the minutest detail, in order to trace the origin of all lodgments and the destination of all payments recorded therein. All cheques drawn by the business in favour of the partners or, in the case of companies, in favour of directors or other officials whose affairs are also the subject of investigation must be traced into their private banking accounts. In the case of any cheques which cannot be so traced, the cancelled cheques, if available, should be examined. If it is found that such cheques are crossed cheques, the names and addresses of the banks through which they were cleared should be noted and enquiries made of the payees as to the manner in which they disposed of the cheques in question. Enquiries on these lines may reveal the existence of banking accounts in the names of the taxpayers or their nominees which have not so far been disclosed to the accountant.

The exact nature of all payments from private banking accounts must be ascertained, even though the amounts involved may be small, as such payments may indicate the existence of assets which have not been disclosed, *e.g.*, a safe deposit rental, a furrier's charge for storage of a fur coat, etc. For the same reason the

nature of the risks covered by all insurance premiums paid must be ascertained.

A total account for receipts and payments of cash, as distinct from cheques, must be prepared for each individual who is the subject of investigation, in order that the accountant may satisfy himself that the person concerned appears to have had sufficient cash to meet his normal household and living expenditure. This account will be compiled as follows:

Debit side.

(*a*) Cash drawn from bank.
(*b*) Cash drawn from business.
(c) Any other cash receipts, *e.g.*, rents collected.

Credit side.

(*a*) Cash paid in to bank.
(*b*) Bank lodgments from unidentified sources which, therefore, are assumed to have represented cash.
(*c*) Payments which must have been made in cash because they were not discharged by checque, *e.g.*, rates or other known expenditure.
(*d*) Cash allowance, if any, to wife for household expenses and to children for pocket money.
(*e*) Any other known cash payments.
(*f*) Estimate of the taxpayer's personal cash expenditure.

If the account prepared in this way reveals an excess of expenditure over cash received, the accountant will be forced to conclude, subject to the accuracy of the estimates made, that the taxpayer has received cash from sources not disclosed by him. Exhaustive enquiries into this possibility must be made, it being impressed upon the taxpayer that a satisfactory report cannot be made to the Income Tax authorities with such a discrepancy unexplained.

Where no books have been kept, it will be necessary to construct accounts by analysing bank statements, invoices, creditors' statements, receipts or invoices for expenditure and any other available documents and data. Unless all cash takings and receipts

from debtors have been paid into the bank, it may be very difficult, if not impossible, to obtain a reliable estimate of the total amount of the sales; but if the total purchases have been ascertained, it may be possible to estimate the amount of the gross profit by reference to the percentage on purchases normally earned in the particular trade, or by adding to the bank lodgments an estimate of the amount of cash takings applied in paying for purchases and expenses, and drawn by the client for his private use.

Where the available data are so meagre that it is impossible to construct Profit and Loss Accounts, the only method of estimating the profit will be by the preparation of statements of "net worth" at the beginning and end of the period under investigation. For this purpose, exhaustive enquiry must be made to ascertain the assets owned and the liabilities of the client at each date. To any increase in net worth disclosed by such statements must be added the estimated amount of the client's living and personal expenses (which, of course, must bear some relation to the style in which he lives), any losses on sale of investments, gambling losses and any other losses of a capital nature, the value of any assets which have been worn out or discarded during the period, and any other items by which the final net worth has been reduced. From the total so found will be deducted any legacies received, insurance maturities, gambling profits, profits on the sale of investments and other capital receipts, and the result may then be taken to represent the total income from all sources during the period of the investigation. From this amount must be deducted the total income from investments, property and other sources on which tax has been paid, and the balance may be regarded as the net profit from the business for the whole period. This amount must be apportioned over the years comprised in the period on such basis as may appear to be equitable, having regard to all the circumstances, and in particular to any information that may be available as to the trend of business over the years in question or the assets owned at intervening dates.

In his report the investigating accountant should indicate fully any deficiencies in the data at his disposal, or matters on which he has been unable to obtain satisfactory explanations, and the extent to which he is able to accept responsibility for the accuracy of the figures disclosed by the accounts.

APPENDIX A

A GUIDE TO COMPANY AUDIT
SECOND EDITION - 1962

ISSUED BY

THE RESEARCH COMMITTEE OF THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

No.	Queries	Comments

PRELIMINARY

Before commencing the audit, the auditor should ascertain the following:

(*a*) Accounting Year.
(*b*) Nature of Company's business.
(*c*) Constitution of the Board of Directors.
(*d*) Constitution of persons in charge of the management.
(*e*) Important provisions of the memorandum and articles of association affecting the accounts.
(*f*) System of Internal control and Internal audit and their effectiveness to determine the extent of audit.
(*g*) List of the Books of Accounts.
(*h*) Compliance of Sections relating to appointment of auditors, (See relevant resolution).
(*i*) Examination of points arising out of the previous year's notes/audit report, having a bearing on the current year's work.

PART-I BALANCE SHEET
ASSETS SIDE

FIXED ASSETS

1 Have you ascertained that Fixed Assets have been segregated under the following heads:—(Two illustrations of Schedules are appended on pages 710 and 711.)
(*a*) Goodwill.
(*b*) Land.
(*c*) Buildings.
(*d*) Leaseholds.
(*e*) Railway sidings.
(*f*) Plant & Machinery.
(*g*) Furniture and Fittings.
(*h*) Development of property.
(*i*) Patents, trade marks and designs
(*j*) Livestock, and
(*k*) Vehicles, etc.

2 (*a*) Have you seen that under each head, the original cost and the additions thereto and deductions therefrom during the year and the total depreciation written off or provided upto the end of the year, have been clearly stated?
(*b*) In 'every' case, where the original cost cannot be

No.	Queries	Comments

ascertained without unreasonable expense or delay, have you seen the valuation shown by the books has been given?

Note: Such valuation should be the net amount at which an asset stood in the Company's books, at the commencement of this Act, after deduction of the amounts previously provided or written off for depreciation or dimunition in value. In this connection, refer to Appendix I appearing on page 707 of this Guide. wherein a detailed note has been given on the Mode of valuation of Fixed Assets.

(*c*) Where any asset covered by para 2(*b*) above is sold, have you ensured that the sale proceeds have been shown as a deduction?

(*d*) In case of reduction of capital or revaluation of the assets, every Balance Sheet after the first Balance Sheet subsequent to the reduction or revaluation, should, in place of the original cost, show the reduced figures and with the date of the reduction.

(*e*) Each Balance Sheet for the first 5 years subsequent to the date of the reduction, should show also the amount of reduction made.

(*f*) Similarly, where sums have been added by writing up the assets, every Balance Sheet subsequent to such writing up should show, in place of the original cost, the increased figures with the date of the increase.

(*g*) Each Balance Sheet for the first 5 years subsequent to the date of writing up, should also show the amount of increase made.

In the case of revaluation of assets, verify the value from expert's report and also see Board's Resolution sanctioning such appreciation.

(*h*) Obtain certificate from the Management to the effect that the Plant & Machinery and other fixed assets shown in the Balance Sheet, are in existence and if encumbered, the details of such encumbrances.

Note: It would be advisable in the case of industrial concerns to suggest to the management, maintenance of Plant Register.

(*i*) Do you think the Depreciation provided is either inadequate or excessive? If so, have you reported on that matter?

No.	Queries	Comments
	(*j*) Have you obtained the management's certificate regarding the adequacy of Depreciation in their opinion?	
	(*k*) Is the method of Depreciation provided, consistent with that of the previous year? If not, have you qualified your report?	
	(*l*) Where assets have been acquired on Hire-Purchase or Instalment Agreement, have you verified that the asset account is not charged with anything more than the cash purchase price?	
	Land:	
3.	Is it freehold or leasehold?	
4.	Have you seen the title deeds and ascertained that they are in the name of the Company or obtained a certificate from the Company's Solicitor, that they are in order?	
5.	Have you ascertained that all legal charges, brokerage paid, etc., for the purchase of land have been properly capitalised?	
6.	In the case of Leasehold Land, have you seen that the provision for write off, is made according to the life of the lease?	
	Buildings:	
7.	Where an existing building is purchased, have you verified the sale deed and other documents?	
8.	If there is a consolidated purchase of land and buildings, have you ascertained whether it is reasonably allocated in the accounts and separated for the Balance Sheet purposes under proper heads? Have you seen the Board's Resolution for the same?	
9.	Where a building is constructed for the Company by an outside contractor, have you verified the cost with reference to the terms of the contract?	
	Plant, Machinery and Equipment:	
10.	Have you seen that all expenses for erection of machinery are properly capitalized and that no revenue expenses are wrongly added to asset accounts?	
	Mines, Quarries, etc.:	

No.	Queries	Comments

11. Have you verified on the occasion of the first audit, the cost with the sale deed and other documents?
Note: Where such assets are not being written down from year to year according to their depletion, it should be considered whether a note to that effect should be made in the accounts.
12. When the lease for such assets has expired, have you seen that they are completely written off in the accounts? Inspect annually the lease deed.

Goodwill:

13. Where there is an increase in the goodwill by revaluation, are you satisfied as to its reasonableness?
14. Where goodwill is purchased, have you ascertained, by reference to the agreement with the vendor, that it is correctly shown in the Balance Sheet at cost, and in other cases, by reference to the Directors' Resolution allocating the purchase price between various assets including goodwill, after satisfying yourself as to its reasonableness?

Patents, Copyrights, Trade Marks, Patterns and Drawings:

15. In the case of the first audit after a patent is purchased, have you verified the cost and life with reference to proper documents?
16. Have you ascertained that only the expenditure of a capital nature on patents is being capitalized?
17. Have you ascertained whether patents and copyrights which have expired, have been written off?

Motor Cars and Trucks:

18. Have you checked the certified inventory of the fleet of cars and trucks, preferably with the Registration Books?

INVESTMENTS:

1. Have you shown separately:

(*a*) investments in Government or Trust securities,
(*b*) investments in shares, debentures or bonds, showing separately, shares fully paid up and partly paid up

No.	Queries	Comments

and distinguishing the different classes of shares,

(*c*) investments in shares, debentures or bonds of the subsidiary companies showing separately, shares fully paid up and partly paid up and distinguishing between the different classes of shares,

(*d*) investments in immovable properties, and

(*e*) mode of valuation against each of the above items (*a*) to (*d*).

2. Have you shown the aggregate amount of the company's quoted investments and also their market value?

3. Have you shown the aggregate amount of the company's unquoted investments?

4. Have you annexed to the Balance Sheet, a statement of investments whether shown under "Investments" or under "Current Assets" as stock-in-trade, separately classifying trade investments and other investments?

Note: A "Trade Investment" means an investment by a company in the shares or debentures of another company not being its subsidiary, for the purpose of promoting the trade or business of the first company.

5 In the above statement, have you stated the names of bodies corporate (with the names of their managing agents or secretaries and treasurers, if any) in whose shares or debentures or bonds, investments have been made and also stated the nature and extent of such investments? Names of the bodies corporate in the same group should be indicated separately:

Note: (*i*) Though Section 372 is not applicable to a private company, it is necessary for the purposes of the Balance Sheet of a private company, to show the investments of the Company in the same group separately.

(*ii*) The above particulars should also include all investments whether existing or not, made subsequent to the date, as at which, the previous balance sheet was made out. However, in the case of an investment company, *i.e.*, a company whose principal business is the acquisition of shares, stock, debentures or other securities, it will be sufficient, if investments existing as on the date of the Balance Sheet are shown.

No.	Queries	Comments

(*iii*) It is not necessary to give any of the particulars mentioned in (4) and (5) above, in respect of investments made by a managing agency or secretaries and treasurers in the managed company's shares or debentures.

6. Have you verified the physical existence of each investment, either by verifying the actual scrip of each share, bond, security, debenture, title-deeds of property, etc., or by verifying by a confirmatory letter?
7. Have you verified in the case of each scrip that it is held in the name of the company?
8. If investments are not so held, have you seen whether or not, there is a breach of Section 49; and also, have you inspected the Register of Investments required to be kept according to Section 49(7) of the Companies Act?
9. Have you seen that the Profit or Loss on the sale of Investments during the year is properly adjusted in the accounts?
10. (1) In respect of investments in shares and debentures:
    (*a*) Have you ensured that the company (hereinafter referred to as the investing company), has adhered to the percentage limits for investment prescribed under Section 372(2) and its two provisos?
    (*b*) Have you ascertained that in computing the aforesaid percentages, the aggregate of the investments made, whether before or after the commencement of the Companies (Amendment) Act, 1960, has been taken into account?
    (*c*) If the investment is in excess of the percentages specified in Section 372 (2) and the provisos thereto, have such investments been sanctioned by a resolution of the investing company in General Meeting and further approved by the Central Government except investments in rights shares?
    (*d*) If the investment has not exceeded the limits of Section 372 (2) and its provisos, have you ensured that the investment has been sanctioned by a resolution of the Board of Directors of the investing company, passed at a meeting of the Board, with the consent of all Directors present

No.	Queries	Comments

at the meeting, except those not entitled to vote thereon? Has notice of the resolution to be moved at such a meeting, been given to every Director, in the manner specified in Section 286?

(*e*) Have you ascertained that the Company has maintained a register required by Section 372(6)?

(2) In respect of investments in companies in the same group:—

(*i*) Has the company obtained the sanction of the Company in a General Meeting and of the Central Government, within the specified period, in respect of investments in excess of the limits prescribed in Section 372, including investments made at any time after April 1, 1952?

(*ii*) If the authority of the shareholders and the approval of the Central Government are not so obtained, have you ascertained that the Board of Directors have disposed of the investments, which are in excess of the limits specified in Section 372(2) and the second proviso thereto, within the prescribed time?

11. If the investment consists of bearer bonds, have you ascertained that all coupons not due are attached to the bonds and that the next coupon to be clipped bears the date of the next interest payment?

CURRENT ASSETS, LOANS & ADVANCES:

(A) CURRENT ASSETS.

(1) Have the Current Assets been classified for the Balance Sheet purposes under the following 'main' heads:

(1) Interest accrued on Investments.
(2) Stores and Spare parts.
(3) Loose Tools.
(4) Stock-in-trade.
(5) Work-in-Progress.
(6) Sundry debtors.
(*a*) Debts outstanding for a period exceeding six months.
(b) Other debts.
Less: Provision:

No.	Queries	Comments

(7) Cash and Bank balances.

(2) Have you seen that the mode of valuation in respect of items (2), (4) and (5) above has been stated?

(3) If in the opinion of the Board of Directors, any of the current assets loans and advances, does not have a value on realisation in the ordinary course of business, at least equal to the amount, at which it is stated in the Balance Sheet, is such fact (that the Board is of that opinion) clearly stated against this item in the Balance Sheet? (Obtain a resolution from the Board).

1. **Interest accrued on Investments:**

(*i*) Have you shown it separately in the Balance Sheet?
(*ii*) Have you verified its basis of computation?

2. **Loose Tools:**

(*i*) Where the Company manufactures its own tools, have you seen that the cost of these is properly ascertained and certified by the Chief Engineer?
(*ii*) Have you seen a certified copy of the inventory of Loose Tools on the Balance Sheet date?

3. **Stock-in-Trade:**

(*i*) Have you shown separately the amount in respect of raw materials?
(*ii*) Have you clearly indicated the mode of valuation?
(*iii*) Have you shown separately the amount in respect of finished goods?
(*iv*) Have you seen the management's certified inventory of stock of finished goods, raw materials, etc. and obtained a certificate in respect of the same for your records?

Specimen Certificate

To (*Date*)

. . . . . .

Chartered Accountants,

. . . . . .

. . . . . .

No.	Queries	Comments

Dear Sirs,

We hereby certify that the inventory as at close of December 31, 19...., summarized as follows:

	Value Rs.	*Mode of Valuation*
(*a*) Raw Materials	.....	.....
(*b*) Work-in-process	.....	.....
(*c*) Finished Goods	.....	.....
(*d*) Stores & Spare Parts	.....	.....
(*e*) Loose Tools	.....	.....
(*f*) Others	.....	.....
Total Rs.		

was taken under the supervision of responsible persons and that:

(1) The inventory is the property of the company and that there is no mortgage, assignment or other lien upon any of the goods listed. (If there is any charge, the same may be stated).

(2) No goods received on consignment have been included.

(3) The quantities listed were on hand and were determined by actual count, weight or measurement.

(4) Excesses/shortages between the physical inventories and book balances amounting to Rs..... have been adjusted in the books of accounts.

(5) The liability for all goods included in the inventory has been taken up in the books, and

(6) Obsolete or unusable goods have been reduced to their net realizable value.

Yours faithfully,

(Sd.).....

(*v*) (*a*) Have you satisfied yourself about the system of stock-taking?

No.	Queries	Comments
	(*b*) Have you ascertained that proper stores and stock records have been maintained?	
(*vi*)	Was the stock of goods held on consignment duly excluded?	
(*vii*)	Were the goods invoiced but not despatched excluded?	
(*viii*)	Were the Stock of Goods sent on consignment duly included?	
(*ix*)	Have you ascertained that the unsold balances on goods sent out on consignment on sale or return, or with branches, are not included at Selling Price?	
(*x*)	Were the purchases entered but goods not received included as "Goods-in-Transit"?	
(*xi*)	Were obsolete and unserviceable goods listed separately?	
(*xii*)	Were the goods received for which purchase invoices are not entered as purchases duly adjusted?	
(*xiii*)	Have you compared the quantities shown by the inventory sheets with the quantities shown by the balances in the stores and stock records, e.g. Stock Ledger, Stores Ledger, Bin Cards, etc., as on the inventory dates?	
Note:	The number of items to be compared depends upon the relative importance of the inventories in the financial statements.	
(*xiv*)	Have you tested the pricing by ascertaining the basis of pricing used?	
(*xv*)	Have Stock Inventories been initialled by persons responsible for counting, pricing, extending, and totalling and by a Director or other senior person in charge of the management?	
(*xvi*)	Have you test-checked that the extensions are correct?	
(*xvii*)	Have you ascertained that the totals of Inventory Sheets are correct?	
(*xviii*)	Have you ascertained that the inventory of Stock-in-Trade is priced on a consistent basis from year to year?	
	Note:	
	(1) The cost price of an article should ordinarily include the incidental charges like freight, insurance, customs duty, clearing and forwarding charges etc.	
	(2) In the case of manufactured articles, where	

No.	Queries	Comments

overheads form an ingredient of cost, it is essential to ascertain that such overheads have been applied on a consistent basis from year to year.

(*xix*) Have you applied test checks to ascertain that the Stores and Stock Ledgers are properly kept?

(*xx*) Have you applied the Gross Profits Test?

Note: It is advisable to compare the percentage of gross profit to turnover with that of previous years, and obtain explanations for material fluctuations, if any.

(*xxi*) Where stocks are larger than those of the previous year, have you ascertained whether it is as a result of some contract anticipated, slow moving stocks, obsolete articles, buying for the future owing to market conditions, etc.?

(*xxii*) Have you obtained the Board's resolution for the adjustment of differences if material, on stock ledger accounts, found by the management on actual physical verification of Stock?

Stock of Goods sent out on Consignment:

(*i*) Have you scrutinized the basis of valuation of such stock?

(*ii*) In valuing such stock at cost, have you seen that it includes freight and all other charges incurred by the Consignor (i.e. the Company)?

(*iii*) Have you verified the stock certificate obtained from the consignee?

(*iv*) If the consignee's certificate dicloses that any goods have been damaged or deteriorated, has proper allowance been made in this respect from the cost?

(*v*) Have you ascertained that the market price of such goods is not lower than the cost?

(*vi*) Have you ascertained that none of such goods is old, obsolete or unsaleable?

(*vii*) Where goods are sent out on consignment at proforma invoice price including a percentage above cost, have you seen that the necessary adjustment is made in respect of consignment goods which remain unsold at the Balance Sheet date to bring them at actual cost?

No.	Queries	Comments

Stock of goods sold on Hire-purchase:

In valuing such stock, have you ascertained that proportionate estimated profit applicable to outstanding instalments is not taken to revenue?

Stock of goods sent out on Sale or Return:

(*i*) Where transactions relating to goods sent on "Sale or Return" have been entered as ordinary sales in company's books, have you seen a schedule of goods not approved of and lying in the hands of customers at the Balance Sheet date?

(*ii*) In such a case, have you seen that an adjustment entry is passed debiting the Sales Account and crediting Debtors Suspense Account with the amount of such goods?

(*iii*) Have you seen that after passing such entry, the goods in the hands of customers are valued at cost (or market price, if lower) and shown both in the Trading Account and the Balance Sheet?

Stock of Packages and Empties:

Where packages and empties are returnable, have you ensured that due adjustment has been made in respect thereof?

4. **Work-in-Progress:**

(*i*) Have you clearly stated the mode of valuation?

(*ii*) If the Company does not have a cost system in operation, have you ascertained that an inventory of work-in-progress was taken at the end of the accounting year?

(*iii*) Have you seen that the work-in-progress is valued at cost, or market price, or cost or market price whichever is lower, or any other consistent basis from year to year?

Note: Market Price, when applied to work-in-progress, means either replacement cost or market price of finished goods less additional cost of completing the product or the job.

(*iv*) Have you ascertained that any reference to bene-

No.	Queries	Comments

fits expected from contracts to the extent not executed, is not made in the Balance Sheet but is made in the report of the Board of Directors?

5. **Sundry Debtors:**

(1) Have you seen that Sundry Debtors have been classified for the Balance Sheet purposes as under:

	Rs.
(*a*) Debts outstanding for a period exceeding 6 months	. . . . .
(*b*) Other debts	. . . . .
Total Rs.	. . . . .
Less: provision Rs.	. . . . .
Rs.	

Further, have you ensured that the following particulars are stated separately?

(*a*) Debts considered good and in respect of which the Company is fully secured.

(*b*) Debts considered good for which the Company holds no security other than the debtors' personal security,

(*c*) Debts considered doubtful or bad.

Out of the above, indicate separately in the inner column:

(*i*) Debts due by the Directors or other Officers of the Company.

(*ii*) Debts due by the Directors or other Officers of the Company or any of them jointly with any other person or persons.

Note: The term "Officer" includes any Director, Managing Agent, Secretaries and Treasurers, Manager, or Secretary; where the managing agent or the Secretaries and Treasurers are a firm, also includes any partner in the firm; and where the managing agent or the Secretaries and Trea-

No.	Queries	Comments

surers are a body corporate, also includes any director, managing agent, secretaries and treasurers or manager of the body corporate; but, save in Section 477, 478, 539, 543, 545, 621, 625 and 633 does not include an auditor of the Company.

(*iii*) Debts due by firms or private companies respectively in which any director is a partner or a director or a member as the case may be.

(*iv*) Debts due by Managing Agents or Secretaries and Treasurers.

(*v*) Debts due by Managing Agents or Secretaries and Treasurers jointly with any other person.

(*vi*) Debts due from other companies under the same management. These should be disclosed with the names of the companies concerned (vide Section 370 for the definition of companies under the same management).

(*vii*) Maximum amount due by the directors or other officers of the company at any time during the year and included in (i), (ii), (iv) and (v) above.

(2) Have you ascertained that the amounts shown under Sundry Debtors include the amounts due in respect of goods sold or services rendered or in respect of other contractual obligations, but do not include any amounts which are in the nature of loans or advances?

(3) Has the provision for Bad or Doubtful Debts been shown as a deduction from Sundry Debtors?

Note: The provision to be shown under this head should not exceed the amount of debts stated to be considered doubtful or bad and any surplus of such provision, if already created, should be shown at every closing under "Reserves and Surplus" (on the liabilities side) under a separate sub-head "Reserve for Doubtful or Bad Debts".

(4) Where Control Account is in use for Sundry Debtors Ledger, have you ascertained that the balance in the Control Account at the end of the accounting period has been tallied with the total of all balances in the subsidiary ledger?

(5) Have you seen whether the balance on the last date of the accounting year has since been realised by

No.	Queries	Comments

the date of audit, by tracing moneys received on account since the last date of the accounting year?

(6) Have you seen that the Company's accountant has prepared a statement, analysing the age of all Sundry Debtors' balances to enable you to decide the extent of doubtful debts?

(7) If confirmatory letters are obtained, have you test-checked them?

(8) Have you obtained full information from the management about each account which you consider doubtful?

(9) Have you seen that credit balances, if any, in the Debtor's Ledger, are not deducted from the list of Sundry Debtors but shown as liabilities?

(10) Have you enquired about the position of goods sent out on V.P.P.? Are these amounts correctly included in Sundry Debtors and properly verified by you with the V.P.P. register?

(11) Does the Company follow a system of issuing cash memos for goods which are not immediately paid for? If so, have you verified that all such uncollected Cash Memos are accounted for as debtors?

(12) Have you obtained the Board's Resolution for bad debts written off and for debts considered doubtful?

(13) Have you paid particular attention to any big items of sales passed through at the close of the accounting year to ascertain that they are genuine? Have you seen that such sales are not subsequently reversed or goods returned? If so, have they been deducted from the figures of Sales?

(14) Have you enquired whether sales include any items of transactions for future delivery of goods?

6. Cash and Bank Balances:

(*i*) Have you shown Cash in Hand separately in the Balance Sheet?

(*ii*) Have you shown total of Current Account Balances separately in the Balance Sheet?

(*iii*) Have you shown total balance on Call Accounts separately in the Balance Sheet?

(*iv*) Have you shown total balance on Deposit Accounts separately in the Balance Sheet?

No.	Queries	Comments

(*v*) Did you verify the Cash in Hand and/or Petty Cash Book Balance?

(*vi*) Have you seen that all Bank Accounts are properly reconciled and the reconciliation statements prepared and have you verified the same?

(*vii*) Have you verified individually the official certificate of the Bank certifiying the Balance on the last day of the accounting year in respect of every current, savings, call and/or fixed deposit account?

(*viii*) Have you placed in your file, all the certificates of balances and also cash verification sheets?

(*ix*) Have you clearly shown on your cash verification sheets details of all separate imprest accounts, verified at the same time, date and hour of counting, name of person carrying out cash verification, and denominations of notes and coins?

(*x*) Have you shown Cash-in-Transit separately and properly verified its existence by looking into the next year's accounts?

(*xi*) Where the balance of cash in hand consists of I.O.Us, and other suspense vouchers, have you seen that the amount is debited to the account of the party concerned?

Note: The practice of showing I.O.Us, as Cash in Hand should be discouraged as it omits to record the transactions taking place from day to day. In such cases, it cannot be said that proper books of accounts as required by Section 209 of the Companies Act have been maintained. All I.O.Us, must be shown in the Balance Sheet under 'Loans and Advances.'

(B) LOANS AND ADVANCES:

(1) Have these been broadly classified for the Balance Sheet purposes under the following main heads:—

(*a*) Advances and Loans to Subsidiaries Rs. .....

(*b*) Bills of Exchange Rs. .....

(*c*) Advances recoverable in cash or in kind or for value to be received, e.g., Rates, Taxes, Insurance, etc. Rs. .....

No.	Queries	Comments

(*d*) Balances on Current Account with Managing Agents or Secretaries and Treasurers. Rs. .....

(*e*) Balances with Customs, Port Trust, etc. (Where payable on demand) Rs. .....

(*f*) Amounts due by Managing Agents or Secretaries and Treasurers (including remuneration received in contravention vide Section 363).

(II) Has the total of the above items of 'Loans and advances' been further reclassified into:—

(*a*) Considered good and in respect of which, the Company is fully secured,

(*b*) Considered good for which the Company holds no security other than the debtor's personal security,

(*c*) Considered doubtful or bad.

Out of the above, the following should be shown separately in the inner column:

(*i*) Due by the Directors or other officers of the Company.

(*ii*) Due by the Directors or other officers of the Company or any of them jointly with any other person or persons.

(*iii*) Due by firms or private companies respectively, in which any director is a partner or a director or member as the case may b

(*iv*) Due by the Managing Agents or the Secretaries and Treasurers.

(*v*) Due by the Managing Agents or the Secretaries and Treasurers jointly with any other persons.

(*vi*) Due from other Companies under the same management. These should be disclosed with the names of the Companies concerned, (vide Section 370 for the definition of Companies under the same management).

(*vii*) Maximum amount due at any time during the year and included in (*i*), (*ii*), (*iv*), (*v*) and (*vi*) above.

(III) Have you ascertained that the provisions of Sections 295 and 369 have been complied with?

No.	Queries	Comments
	(IV) Where loans have been given to companies under the same management within the meaning of Section 370(1), have you ascertained that the lending company has been authorised to do so by a special resolution?	
	(V) Have you verified the individual balances of Loans and Advances in the Ledger with the list of Loans and Advances?	
	(VI) Have you seen whether the balance on the last date of the accounting year has since been realised by the date of audit, by tracing moneys received on account since the last date of the accounting year?	
	(VII) Have you verified whether the provisions of Section 370(A) have been complied with by the Company?	
	(VIII) Have you verified the analysis of the age of 'Loans and Advances' prepared at your request by the Company's accountant?	
	(IX) If confirmatory letters are obtained, have you test-checked them?	
	(X) Have you obtained full information from the management about each account which you consider doubtful?	
	(XI) In the case of secured loans, have you inspected the securities, collaterals and other documents of title and ensured that the security is adequate and the title is clear?	
	(XII) In the case of advances, have you seen a certified schedule, giving full particulars regarding each advance or prepaid expense?	
7.	**Advances and Loans to Subsidiaries:**	
	(*i*) Have these been shown separately in the Balance Sheet?	
	(*ii*) Have you obtained confirmation of Balances?	
8.	**Bills of Exchange:**	
	(*i*) Have you verified the actual Bills in hand with the Balance of Bills Receivable Account in the Ledger? (If Audit is carried out sometime after the end	

No.	Queries	Comments

of the accounting year, complete verification will not be possible, as some bills must have been paid on maturity date. Such cases will therefore have to be scrutinized by referring to Cash Book entries).

(*ii*) Have you verified whether any bills are overdue?

(*iii*) If there are any Bills of large amounts, have you obtained direct confirmation from the party?

(*iv*) Are there any Bills Receivable from the Managing Agents, the Secretaries and Treasurers, or Subsidiary Companies? If so, are they shown separately?

(*v*) In respect of Bills discounted or endorsed away and remaining unmatured at the date of audit, have you seen that contingent liability in respect thereof is noted at the foot of the Balance Sheet?

9. **Advances recoverable in cash or in kind or for value to be received:**

(*a*) Have you shown them separately?

(*b*) **Advances to officers:**

Note: The term "Officer" includes any Director, managing agent, secretaries and treasurers, manager or secretary; where the managing agent or the secretaries and treasurers are a firm, also includes any partner in the firm; and where the managing agent or the secretaries and treasurers are a body corporate, also includes any director, managing agent, secretaries and treasurers or manager of the body corporate; but save in Section 477, 478, 539, 543, 545, 621, 625 and 633 does not include an auditor of the company.

(*i*) Have you got the balances confirmed by officers and employees of the Company?

(*ii*) Are there any doubtful or overdue balances? If so, what steps are taken for writing off or providing for the same?

10. **Balances on Current Account with the Managing Agents etc.:**

(*i*) Have you ensured that current accounts with the Directors, Managing Agents, Secretaries and Trea-

No.	Queries	Comments

surers or Manager, if in debit, have been shown separately?

(*ii*) Have you obtained confirmation of balances?

(*iii*) Does the account comply with restrictions and limitations laid down in Section 369(2)?

11. **Balances with Customs, Port Trust etc., (where payable on demand):**

(*i*) Have you ascertained the conditions under which such deposits were made?

(*ii*) Have you verified the deposit receipts or other correspondence, if any?

(*iii*) Have you obtained confirmation of balances from the parties?

12. **Provision for Bad or Doubtful Debts:**

Note: If a provision is made in respect of any item of Loans and Advances which are doubtful or bad, it should be treated on the same lines as indicated under the heading "Sundry Debtors" (See note earlier under the head "Sundry Debtors").

MISCELLANEOUS EXPENDITURE:

(to the extent not written off or adjusted)

Have these been classified separately, for the Balance Sheet purposes as follows:—

(1) Preliminary expenses: Have you verified the figure of Preliminary Expenses with the amount stated in the Prospectus, if any?

(2) Expenses including commission or brokerage on underwriting or subscription of shares or debentures.

(3) Discount allowed on the issue of shares or debentures.

(4) Interest paid out of capital during construction, stating the rate of interest. Have you verified if such payment complies with the requirements of Section 208?

(5) Development Expenditure not adjusted.

(6) Other items (specifying nature).

PROFIT & LOSS ACCOUNT:

Have you seen that the debit balance of profit and

No.	Queries	Comments

loss account carried forward after deduction of the uncommitted Reserves, if any, has been shown against this item?

LIABILITIES SIDE

SHARE CAPITAL:

1. Has the 'authorised capital' been shown separately in the Balance Sheet?
2. Have you shown the issued as well as subscribed capital? Have you shown particulars in respect of each class of issued and subscribed capital?
   Note: Under Section 85 of the Act, "Preference Share Capital" means only shares which carry both the following rights:
   (*a*) Preferential right to payment of dividends, and
   (*b*) Preferential right for repayment of Capital on winding up.
   If any share capital carries only one of these two preferential rights, it will have to be treated as Equity Capital.
3. What is the amount called up in respect of each class of shares?
4. How many shares of each class are allotted as fully paid up pursuant to a contract without payments being received in cash?
5. How many shares of each class are allotted as fully paid up by way of bonus shares? Have you specified the source from which bonus shares are issued *e.g.*, capitalisation of profits or Reserves or from Share Premium Account.
6. What is the total amount of calls unpaid?
   They should be classified as under:—
   (*i*) by managing agent or secretaries and treasurers; and where the managing agent or the secretaries and treasurers are a firm, by the partners thereof; and where the managing agent or the secretaries and treasurers are a private company, by the directors or members of that Company,
   (*ii*) by the Directors,
   (*iii*) by others.
7. Have you obtained from the management, a list of calls in arrears made out from the Register of Members and

No.	Queries	Comments

reconciled with the debit balances in the Share allotment or Share Call Accounts in the Financial Ledger?

8. Where there is only one class of shares issued by the Company, has it been styled as equity capital in the Balance Sheet?

   Note: Non-Subsidiary Private Companies and Companies formed prior to the commencement of the Act, may however retain their old nomenclature *e.g.*, ordinary Shares.

9. Where the Company has issued Redeemable Preference Shares, have the terms of redemption or conversion, if any, been clearly shown together with the earliest date of redemption or conversion?

10. Have full particulars of the option on unissued share capital, if any, been given?

11. Has the amount originally paid up in respect of forfeited shares, if any, been added to the share capital and separately shown?

12. Have you seen that capital profit, if any, on re-issue of forfeited shares, has been transferred to Capital Reserve?

Forfeiture of Shares:

13. (*i*) Have you ascertained that the detailed procedure as laid down in the Articles of the Company has been fully complied with before forfeiture?

    (*ii*) Is forfeiture permitted by the Articles of the Company?

    (*iii*) Have you examined the Directors' Resolution forfeiting the shares?

    (*iv*) Have you examined the entries in the books of accounts for the forfeiture?

    (*v*) Where forfeited shares are sold or re-issued, have you verified that such shares have not been re-issued at a price less than the difference between the called up value of shares and the amount, if any, actually realised from the defaulting shareholder?

    Note: Where the company has realised premium on issue of shares which are subsequently forfeited, the premium collected should remain to the credit of Share Premium account and not transferred to Forfeited Shares Account.

No.	Queries	Comments

Issue of New Share Capital:

14. Has any fresh Share Capital been issued during the period under audit? If so, have you verified that the principles embodied in Section 81 have been complied with?
15. In the case of the first audit after every new issue of shares, have you ascertained the following:
    (*a*) Have you seen that the Capital issued does not exceed the Authorised Capital?
    (*b*) Where permission is necessary from the Controller of Capital issues, is it obtained and the prescribed conditions complied with?
    (*c*) Have you checked the share application with the Application and Allotment Book to see that the shares allotted have been actually applied for?
    (*d*) Have you examined Board's resolution regarding allotment of shares?
    (*e*) Have you vouched the moneys received on application and allotment with the counterfoil receipts or other relevant evidence?
    (*f*) Where any calls have been made, have you seen the Directors' Resolution for the same?
    (*g*) Have you seen that the total cash received on account of share capital agrees with the credit balance on share capital account less debit balance of Allotment and Call Accounts, if any, in the financial ledger?
    (*h*) Have you noted whether the directors have taken up their qualification shares and have paid for them to the same extent as other shareholders?
    (*i*) Where shares are allotted for consideration other than cash, have you examined the contract constituting the allottee's title to the shares with the director's minutes and mentioned in the Prospectus or statement in lieu thereof, if any, authorising the allotment?
    (*j*) Where shares are issued at a premium, have you seen that the premium is shown distinctly under the head "Reserves and Surplus", and not under "Share Capital"?
    (*k*) "Have you seen that all moneys received from applicants for shares at the time of first public issue are placed in a Scheduled Bank till the certificate

No.	Queries	Comments

of the commencement of business has been obtained?"

16. Particulars of Shares held by Holding Company or the Ultimate Holding Company:

Note: This item refers to the head "Share Capital" and not to the head "Investments."

In the case of Subsidiary Companies, the number of shares held by the holding company as well as the ultimate holding Company and its subsidiaries must be separately stated.

(Auditor is not required to certify the correctness of the above shareholdings).

RESERVES AND SURPLUS:

1. Have these been classified under the following heads in the Balance Sheet:
   (1) Capital Reserves.
   (2) Capital Redemption Reserve.
   (3) Share Premium Account.
   Note: The item "Share Premium Account" should include details of its utilisation in the manner provided in Section 78 in the year of utilisation.
   (4) Other Reserves specifying the nature of each reserve and the amount in respect thereof.
   Less: Debit balance in Profit and Loss Account (if any).
   Note: Have you seen that the debit balance in the P. & L.A/c. has been shown as a deduction from the uncommitted Reserves, if any?
   The expression "uncommitted reserves" would not include such reserves as are set aside for a specific purpose such as Reserve for Doubtful Debts, Investment Fluctuation Reserve etc. and/or which are not available for distribution as dividend under the Act. such as Share Premium Account, Capital Reserve, etc.
   (5) Surplus, i.e. balance in Profit and Loss Account, after providing for proposed allocations viz., Dividend, Bonus or Reserves.

No.	Queries	Comments

(6) Proposed additions to Reserves.

Note: Where it is necessary to obtain sanction of shareholders to any transfers to Reserves (by Articles or otherwise) the proposed transfers to reserves, will necessarily have to be shown separately under this head.

(7) Sinking Funds.

Note: The word "fund" in relation to any "Reserve" should be used only where such Reserve is specifically represented by earmarked investments.

2 Under each of the above heads, have you distinctly shown additions and deductions, if any, since the last Balance Sheet?

3. In the classification of Reserves, have you clearly observed the distinction between Reserves and Provisions?

Note: The term "provision" would include any amount retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy; *e.g.*, Provision for Taxation.

4. Have you ascertained that the item "Capital Reserve" does not include any amount which is regarded as free for distribution through the profit and loss account?

5 Have you ascertained that the "Reserves" do not include any amount written off or retained by way of providing for depreciation, renewals or diminution in the value of assets or retained by way of providing for any known liability?

6. Where any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, not being an amount written off in relation to fixed assets before the commencement of this Act; or where any amount retained by way of providing for any known liability, is in excess of the amount, which in the opinion of the directors is reasonably necessary for the purpose, have you ascertained that such excess is shown as a "Reserve" and not as a provision?

Secured Loans:

1. Have these been classified under the following heads for the Balance Sheet purposes:

(*a*) Debentures.

No.	Queries	Comments

(*b*) Loans and Advances from Banks.
(*c*) Loans and Advances from subsidiaries.
(*d*) Other Loans and Advances.

Note: 1 Have you seen that loans from the Directors, the Managing Agents, the Secretaries & Treasurers, and Manager, have been shown separately?

2. Have you seen that Interest accrued and due on Secured Loans has been included under each of the above sub-heads (a) to (d) mentioned above?

2. In each of the above cases, has the nature of the security been clearly indicated?

Note: The Auditor should obtain a certificate from the lender concerned, giving details of the nature and extent of the security, including amounts guaranteed by the Directors, the Managing Agents etc.

3. Where in any of the above cases, loans etc., have been guaranteed by the managing agents, the secretaries and treasurers, managers and/or directors, have these been mentioned clearly that they are so guaranteed?

4. In case of (3) above, has the aggregate amount of such guaranteed loans been also mentioned under each of the four heads?

5. Have the terms of redemption or conversion, if any, of debentures issued been mentioned together with the earliest date of redemption or conversion?

6. Have particulars been given under (1) (a) above, of any redeemed debentures which the company has power to re-issue?

7. Where any of the company's debentures are held by a nominee or a trustee for the company, has the nominal amount of such debentures and the amount at which they are stated in the books of the Company been clearly indicated?

8. Have you ascertained the company's borrowing powers and seen that they are not exceeded? In this respect, has the Company complied with the restrictions laid down in Section 293(d)? Have you seen the .Board's resolution for all loans borrowed and noted their terms and conditions laid down in the minutes book?

Note: Where the Board has delegated its authority under Section 292, the terms and conditions in such cases should also be verified.

No.	Queries	Comments

9. Issue of Debentures:
   (*a*) Upon a new issue of Debentures, have you carried out the detailed Debenture Capital Audit in the same manner as in the case of the Share Capital Audit described in detail earlier?
   (*b*) Have you inspected and noted the terms of the Debenture Trust Deed?
   (*c*) Have you carefully scrutinized the terms of Debenture Issue and seen that they are properly complied with?
   (*d*) Have you seen that the provisions regarding the redemption of debentures have been complied with?
   (*e*) Have you seen that the balance on Debenture Account in the Financial Ledger has been reconciled with the balances extracted from the Register of Debenture-holders?
   (*f*) Where various classes of Debentures are issued, such as First and Second Mortgage Debentures, have you seen that they have been separately shown in the Balance Sheet?
   (*g*) Have you seen that the remuneration payable to Trustees for Debenture-holders under the Trust Deed has been duly paid or provided for in the Accounts?
   (*h*) Where debentures are issued at a premium and if the company desires to take credit for it in the Profit & Loss Account, have you consulted the company's articles to ascertain that they do not prohibit such a procedure?
   (*i*) In the above case, have you also taken care to see that this item is shown clearly and separately in the Profit and Loss Account?

Unsecured Loans:

1. Have these been classified in the Balance Sheet as under:—
   (*i*) Fixed Deposits.
   (*ii*) Loans and Advances from Subsidiaries.
   (*iii*) Short term loans and advances:
      (*a*) From Banks.
      (*b*) From Others.

   Note: Short term loans will include those which are due

No.	Queries	Comments

for not more than one year as at the date of the Balance Sheet. This wording is taken to mean loans which are due for repayment within a period of not more than one year from the Balance Sheet date.

(*iv*) Other loans and advances:
  (*a*) From Banks.
  (*b*) From Others.

2. Have you ascertained the company's borrowing powers and seen that they are not exceeded? (See Section 293 (d))
3. Have you scrutinized the conditions of the loan?
4. Have you seen the Board's Resolution for all loans borrowed and noted their terms and conditions as laid down in the Minutes Book?
5. Where unsecured loans in (*ii*), (*iii*) & (*iv*) of (1), above have been guaranteed by the managing agents, the secretaries and treasurers, managers and/or directors, have you made a mention thereof in the Balance Sheet and also of the aggregate amount of such loans under each separate head?

   Note: It would be sufficient if the Auditor obtains for his record, a certificate from the management giving the above particulars.
6. Have you seen that loans from the Directors, the Managing Agents, the Secretaries and Treasurers and the Manager have been shown separately?
7. Have you seen that Interest accrued and due on unsecured loans has been included under the appropriate sub-heads under the head 'Unsecured Loans'?

CURRENT LIABILITIES AND PROVISIONS:

1. Have these been classified in the Balance Sheet as under:—

(A) CURRENT LIABILITIES:

(1) Acceptances.
(2) Sundry Creditors.
(3) Subsidiary Companies.
(4) Advance payments and Unexpired Discounts for the portion for which value has still to be given, e.g., in the case of the following classes of companies:—

No.	Queries	Comments

Newspaper, Fire Insurance, Theatres, Clubs, Banking, Steamship Companies etc.

(5) Unclaimed Dividends.

(6) Other Liabilities (if any).

(7) Interest accrued but not due on loans

(B) PROVISIONS:

(8) Provision for Taxation.

(9) Proposed Dividends.

(10) For contingencies.

(11) For Provident Fund Scheme.

(12) For Insurance, Pension and similar Staff Benefit Schemes.

(13) Other Provisions.

2. Have you obtained a certificate from the management that all known liabilities are put through the books of accounts?

(1) **Acceptances:**

(*i*) Have you compared the balance of the Bills Payable Account in the ledger with the Bills accepted and not matured at the date of the Balance Sheet as shown by the Bills Payable Book?

(*ii*) Have you ascertained that no Bills Payable are left out to be entered in the Books of Accounts as far as you are able to verify?

(*iii*) If Bills Payable are issued out of a regular counterfoil book, have you gone through the counterfoils to verify running numbers of bills issued and examined the counterfoils with the Bills Payable Register looking out for cancelled forms not attached to counterfoils, if any?

(*iv*) Have you called for and obtained confirmation from parties to whom bills or large amount if any, have been issued?

(*v*) Have you verified the calculations of interest accrued on Bills Payable, if any?

(2) **Sundry Creditors:**

(*i*) Where a control account for creditors is kept, have you ascertained that the balance in the control ac-

No.	Queries	Comments

count actually tallies with the total of individual balances in creditors ledger?

(*ii*) Is there a proper system of reconciliation for the above?

(*iii*) Have you ascertained that accounts with creditors only are included in the item of Sundry Creditors and not other items like loans, etc.?

(*iv*) Are there any debit balances in creditors ledger? If so, they must be shown on the assets side of the Balance Sheet, under the appropriate head.

(*v*) Have you verified outstanding purchases, expenses, etc., especially with reference to subsequent period's accounts?

(*vi*) Have you compared statements received from creditors, if any, with the balances shown by the accounts and investigated differences?

(*vii*) Have you examined the director's minutes book for liabilities assumed or contracts made, if any?

(*viii*) Have you considered the question of provision for Central & State Sales Taxes payable, if any?

(3) Subsidiary Companies:

Have you ascertained that all current liabilities owed to subsidiary companies (of whatever nature) are shown separately in the Balance Sheet?

(4) Advance Payments and Unexpired Discounts:

Have you ascertained that advance payments and unexpired discounts for the portion for which value has still to be given, as for example, in the case of the following classes of companies: Newspaper, Steamship, Airline Companies, Theatres, Clubs etc., have been shown under the above head?

(5) Unclaimed Dividends:

Have you inspected the schedule of unclaimed dividends and ascertained that the total of unclaimed dividends agrees with the total of the individual balances?

(6) Interest Accrued but not due on Loans:

(*i*) Has interest accrued but not due on secured and

No.	Queries	Comments

unsecured loans been shown separtely in the Balance Sheet under the above heading?

(*ii*) Have you verified by test checking, the correctness of the above interest computations?

(7) Provision for Taxation:

(*i*) Have you ascertained that this item consists only of such amount as can be rightly regarded as "Provision for Taxation" and not any amount which should be shown as "Reserve for Taxation", being in excess of what is reasonably necessary for the purpose?

(*ii*) Have you seen that proper provision has been made for Taxation with due regard specifically to the following:

(*a*) Income-Tax and Super-tax as computed at the appropriate rates,

(*b*) Excess Distribution Tax payable (i.e. additional Super-tax), if any,

(*c*) Capital Gains-tax payable,

(*d*) Penal tax provided for or necessary under Section 23A of the Income-Tax Act, 1922 (New Act—Section 104),

(*e*) Wealth-tax payable, if any,

(*f*) Gift-tax payable, if any,

(*g*) Estate Duty as a Controlled Company,

(*h*) Penalty payable under any Tax Acts,

(*i*) Payment of tax in a foreign country,

(*j*) Rebates due for Double Taxation Relief, if any,

(*k*) Disallowable expenses, if any,

(*l*) Development Rebate & Development Rebate Reserve Account,

(*m*) Allowance for depreciation, extra shift allowance etc.,

(*n*) Relief if any, due under Section 15C of Income-Tax Act, (New Act—Section 84),

(*o*) Relief if any, due under Section 56A of Income-Tax Act, (New Act—Section 99),

(*p*) Adjustments made to Provision for Taxation Account upon completion of assessments and determination of actual liability,

(*q*) Consideration of past losses and arrears of depreciation allowances?

No.	Queries	Comments

(8) **Proposed Dividends:**

(*i*) Have you ascertained that proposed dividends (recommended by the Board) for all classes of shares are duly shown in the Balance Sheet?

(*ii*) Have you examined special provisions, if any, in the Memorandum or Articles, regarding payment of dividends?

(*iii*) Have you examined the minutes of the Board meeting for proposed dividends?

(*iv*) Have you ascertained that this item does not include unpaid dividends which must be shown separately from proposed dividends?

(*v*) Has the amount of dividend before deduction of Income-tax been stated in the Balance Sheet?

(*vi*) Where there are tax-free dividends, has the amount been shown as free of Income-tax and the fact that it is so shown stated?

(*vii*) In the case of dividend on preference shares, wherever applicable, have you seen that the provisions of the Preference Shares (Regulation of Dividends) Act 1960 have been complied with?

(9) **Provision for Contingencies, Provident Fund, Insurance, Pension, and Similar Staff Benefit Schemes, etc.:**

Have you satisfied yourself regarding the adequacy or otherwise of provision for contingencies etc., made, if any?

(10) **Balances on Current Account with Managing Agents, etc.:**

Have you seen that Current Accounts with Directors, Managing Agents, Secretaries and Treasurers, or Manager if in credit, have been shown separately?

Note: This would apply equally to all heads, viz.,

(*a*) Secured Loans,

(*b*) Unsecured Loans,

(*c*) Current Liabilities and Provisions.

(11) **Foot-Note:**

1. The following should be shown separately as a foot-note to the Balance sheet:

No.	Queries	Comments

(*i*) Claims against the company not acknowledged as debts,

(*ii*) Uncalled liability on shares partly paid,

(*iii*) Arrears of Fixed cumulative dividends.

The period for which the dividends are in arrear should be clearly indicated, or if there is more than one class of shares, the period for which the dividends on each such class are in arrear together with the amount, should be stated.

Note: The term "arrears of dividend" must be clearly understood. It is considered that the dividend is in arrear in respect of a particular year, if at the General Meeting which considers the accounts for that year, no dividend is declared. If, however, the Articles of Association or the terms of issue provide that the fixed cumulative dividend shall be payable on certain dates, then the dividend will be in arrear, if that date has passed and no dividend has been paid.

(*iv*) Estimated amount of contracts remaining to be executed on capital account and not provided for.

Note: It is considered that this requirement relates to financial provisions. Advances made against contracts remaining to be executed should be considered as amounts provided for.

(*v*) Other money for which the company is contingently liable, such as—

(*a*) Suits filed against the company.

(*b*) Matters under arbitration.

(*c*) Pending labour demands.

(*d*) The amount of any guarantees given by the company showing separately the amount of any guarantees given on behalf of directors or other officers of the company.

(*e*) Where practicable, the general nature and amount of each such contingent liability, if material.

(*f*) In respect of Bills Receivable discounted and not matured.

(*g*) In respect of penalties under contracts.

No.	Queries	Comments

2. Have you obtained a certificate from the management regarding all contingent liabilities?

PART II—PROFIT & LOSS ACCOUNT

Note:

(*a*) The Profit & Loss Account should be so made out as clearly to disclose the result of the working of the company during the period covered by the account.

(*b*) It should clearly disclose every material feature including credits or receipts and debits or expenses in respect of non-recurring transactions or other transactions of an exceptional nature which must be shown separately.

(*c*) The Profit & Loss Account should clearly set out the various items relating to income and expenditure of the Company arranged under the most convenient heads.

(*d*) The Schedule, at several places, refers to the words "if material" or "if material in amount". These words are not defined in the Act. This is a matter within the discretion of the directors. The auditor should report if he takes a view different from that of the directors.

(*e*) **It should clearly show separately the following information in respect of the period covered by the account:—**

(i) Sales, etc.:

(*a*) The total turnover, that is, the aggregate amount for which sales are effected by the Company.
Note: The term 'turnover' would mean the total sales after deducting therefrom goods returned, price adjustments, trade discount, and cancellation of bills for the period of audit, if any.

(*b*) Commission paid to sole selling agents within the meaning of Section 294 of the Act.

(*c*) Commission paid to other selling agents.

(*d*) Brokerage and discount on sales other than the usual trade discount. It should be noted that

No.	Queries	Comments

the usual trade discount may be deducted from the turnover. However, cash discount should be shown separately.

(ii) **Stocks, Purchases etc.:**

(*a*) **In the case of manufacturing concerns:—**

(*i*) The total purchases of raw material; (Sales of raw material must be shown separately)

It is recommended that the following should be separately stated in respect of raw materials:—

(*a*) Opening Stock:
(*b*) Purchases:
(*c*) Closing Stock:
(*d*) Sales, if any:

(*ii*) The opening stock of goods produced and
(*iii*) The closing stock of goods produced.

(*b*) **In the case of trading concerns:—**

(*i*) The total purchases made:

Note: The term 'total purchases made' may include the cost of goods purchased plus all other incidental charges and expenses, such as customs duty, freight, insurance, clearing charges, Mukadami, etc., where incurred.

(*ii*) Opening stock of goods:
(*iii*) Closing stock of goods:

(*c*) **In the case of concerns rendering or supplying services:—**

The gross income derived from services rendered or supplied.

Note: (*i*) The term 'gross income' would mean gross profit of the particular activity and not necessarily the gross receipts, e.g. in the case of a travel agent, the gross profit of a particular tour.

(*ii*) Overhead expenses and establishment expenses cannot be deducted in arriving at gross income.

(*d*) **In the case of concerns which fall under more than**

No.	Queries	Comments

one of the categories mentioned under clauses (ii) (a), (b) and (c) above:—

It shall be a sufficient compliance of the requirements herein, if the total amounts are shown in respect of the opening and closing stocks, purchases and sales and the gross income from services rendered is shown.

(*e*) **In the case of other concerns:—**

The gross income derived under the different heads. (See Notes (*i*) & (*ii*) about gross income, as in (*ii*) (*c*) above).

(iii) **Work-in-Progress:**

In the case of all concerns, having work-in-progress:

(*a*) The amount for which such works have been completed at the commencement of the accounting period.

(*b*) The amount for which such works have been completed at the end of the accounting period.

Note: In the case of manufacturing concerns, the opening and closing stocks of semi-finished goods, or opening and closing stocks of work-in-progress, as the case may be, should be shown separately.

(iv) **Depreciation:**

(*a*) The amount provided for depreciation, renewals or diminution in value of fixed assets; *e.g.*, provision for renewals, if any, or obsolescence loss written off, if any. Where the provision stated above is not made by means of a depreciation charge, but by some other method, the actual method adopted for making such provision and the amount. For example, where no charge for depreciation is made to the profit & loss account, but the amount is debited to, say, Depreciation Reserve Account, or to any other Reserve, the fact must be stated on the face of the profit and loss account.

No.	Queries	Comments

(*b*) If no provision is made for depreciation in respect of any fixed asset, the fact that no provision has been made, shall be clearly stated and the quantum of arrears of depreciation computed in accordance with Section 205(2) of the Act shall be disclosed by way of a note.

Note: Any departure from the normal practice regarding depreciation must be investigated and, if necessary, clearly brought out by way of a note or in the auditors' report.

(v) **Interest on Debentures and other fixed loans:**

(*a*) The total amount of interest on Company's debentures and other fixed (long-term) loans.
(*b*) The amount out of interest stated above, paid or payable to Managing Director.
(*c*) The amount out of interest stated above, paid or payable to Managing Agents.
(*d*) The amount out of interest stated above, paid or payable to Secretaries and Treasurers.
(*e*) The amount out of interest stated above, paid or payable to Manager.

(vi) **Taxes on Income:**

(*a*) The amount of charge for Indian Income-tax.
(*b*) The amount of charge for other Indian Taxes on Profits.
(*c*) The amount of taxes imposed elsewhere, to the extent of relief, if any, available from Indian Income-tax.
(*d*) Different taxes should be shown separately as far as practicable, *e.g.*, Income-tax, Wealth-tax, Excess Profits-tax, Business Profits-tax etc.

Note: Also see "Provision for Taxation" at page 683.

(vii) **Repayments:**

(*a*) The amounts reserved for repayment of Share Capital, *e.g.*, Redeemable Preference Shares.
(*b*) The amount reserved for repayment of loans, *e.g.*, debentures.

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(viii) Reserves:

(*a*) The aggregate, if material, of any amounts set aside or proposed to be set aside to Reserves (but not provisions).

(*b*) The aggregate, if material, of any amounts withdrawn from such Reserves.

(ix) Provisions:

(*a*) The aggregate, if material, of the amounts set aside to Provisions (made for meeting specific liabilities, contingencies or commitments, known to exist at the date at which the Balance Sheet is made up, but whose amount cannot be determined with substantial accuracy, vide Part III, Schedule VI, Clause (7)(1)(a) of the Companies Act; *e.g.*, Provision for damages incurred, provision for bonus, etc.).

Note: Definite amount provided for bonus ascertained with sufficient accuracy is not a provision.

(*b*) The aggregate, if material, of the amounts withdrawn from such provisions, as are no longer required.

Note: It is clear from the Act that so far as the Balance Sheet is concerned, all additions to or deductions from Reserves which have taken place since the date of the preceding Balance Sheet, whether material in amount or not, must be disclosed. It is for consideration whether in all cases, such additions or deductions must be passed through the Profit and Loss Account.

Clause 3 of Part II of Schedule VI states that the Profit and Loss Account shall set out the various items relating to the income and expenditure of the company and give details of specific items "in respect of the period covered by the account", particulars of which must be disclosed. If, therefore, an addition to or a deduction from a Reserve has no impact on the profit or loss of the period of account, it would seem that such addition or deduction is not

No.	Queries	Comments

required to be passed through the Profit and Loss Account.

Various types of additions to and deductions from Reserves will be encountered in practice. These are as follows:

(1) **Transfer from Reserve to Reserve:** An example would be a transfer from Dividend Equalisation Reserve to General Reserve. The profit or loss of the period of account is in no way affected by a transfer of this kind and it is accordingly not necessary to pass it through the Profit and Loss Account.

(2) **Transfer from Provision to Reserve:** An example would be the transfer to General Reserve of an excess Provision for Taxation made in a previous year. As in (1) above, the emergence of the excess has no bearing on the profit or loss of the period of account and accordingly it is not necessary to pass the transfer through the Profit and Loss Account. It would not, of course, be proper to retain the excess as a provision, as it is in fact, a reserve.

(3) **Transfer from Reserve to Provision:** An example would be a provision for a liability to be created by withdrawing the required amount from General Reserve. In this case, it is clear that the Profit and Loss Account would not be 'true and fair', if it were relieved of a debit item by reason of a direct transfer from a Reserve to a Provision. In a case of this kind, a debit to Profit and Loss Account must be made and the transfer from Reserve credited thereto.

(4) **Transfer from Provision to Provision:** The comments in (2) and (3) above cover the position regarding transfers to and from Provisions, except the case of a transfer from one provision to another. In such a case, the considerations set out in (3)

No.	Queries	Comments

above apply and the relative entries should be passed through the Profit and Loss Account.

(x) **Other Expenditure:**

(*a*) Consumption of Stores & Spare Parts.

Note: It is not necessary to show separately, opening and closing stocks and purchases. Stores and Spare Parts used for capital purposes should be capitalised and should not be included in the Profit and Loss Account. Alternatively, the total expenditure on Stores and Spare parts may be charged to Profit & Loss Account and separate credit taken for the expenditure which is to be capitalised.

(*b*) Power and Fuel Consumption.
(*c*) Rent.
(*d*) Repairs to Buildings.
(*e*) Repairs to Machinery.
(*f*) (1) Salaries, Wages & Bonus: This will also include such items as retrenchment compensation, gratuity allowances etc., payable to employees. (See also note regarding capitalisation of expenses under "consumption of Stores and Spare Parts").
(2) Contributions to Provident and other Funds.
(3) Workmen & Staff Welfare Expenses, to the extent not adjusted from any previous provision or reserve. This item will include the running costs of those departments which contribute to the welfare of employees *e.g.*, canteen expenses, medical expenses, Employees State Insurance Contributions, etc.
Note: Information in respect of this item should also be given in the Balance Sheet under the relevant provision or reserve account.
(*g*) Insurance Premia.
(*h*) Rates & Taxes (other than taxes on Income) *e.g.*, Local Taxes, Property-tax, Water-tax, Vehicle-tax, etc.,

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(*i*) **Miscellaneous Expenses.**

Note: Contributions to any Political party or for any political purpose, (Section 293A) should be disclosed separately.

Give particulars of the total amount contributed and the name of the party, individual or body to which or to whom such amount has been contributed.

Where a provision has been made for future gratuities payable, what is the basis? Have you obtained the Board's Resolution for the same?

Note: It is recommended that other important heads of expenditure should also be shown separately.

(xi) (a) **Income from Investment:**

(*i*) Amount of Income from Trade Investments. (See also 'Trade Investment' at page 657. para No. 4 under 'Investments').

(*ii*) Amount of Income from other Investments.

(b) **Interest:**

Other income by way of interest specifying the nature of income.

(c) **Income-tax:**

The amount of Income-tax deducted where (xi) (a) (i) and (xi) (a) (ii) are shown

(xii) **Profits or Losses on Investments:**

(*a*) Profits or Losses on sale, realisation, etc. of investments, to the extent not adjusted from any previous provision or reserve.

Note: (*i*) If investments are revalued by the directors, the increase or decrease in value should be shown separately in the Profit & Loss Account, if not adjusted to any provision or reserve.

(*ii*) Information in respect of this item

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should also be given in the Balance Sheet under the relevant provision or reserve account.

(*b*) Profits or Losses in respect of transactions of a kind not usually undertaken by the Company or undertaken in circumstances of an exceptional or non-recurring nature, if material in amount.

(*c*) Miscellaneous Income.

(xiii) Subsidiaries:

(*a*) Dividends from Subsidiary Companies.

Note: Dividends declared by Subsidiary Companies after the date of the Balance Sheet should not be included, unless they are in respect of a period which closed on or before the date of the Balance Sheet.

(*b*) Provision for losses of subsidiary companies.

(xiv) Dividends:

The aggregate amount of the dividends paid and proposed, clearly stating whether such amount are subject to deduction of Income-tax or not.

(xv) Changes in the basis of Accounting:

Amount, if material, by which any items shown in the Profit & Loss Account are affected by any change in the basis of accounting, *e.g.*, mode of valuation of Stock or work-in-progress, change from cash to Mercantile system of accounting, any change in the method of depreciation provision, etc.

Further Information in Profit & Loss Account:

Note:

(A) The profit and loss account shall contain or give by way of a note, detailed information, showing separately the following payments provided or made during the financial year, to the directors (including managing directors), the managing agents, secretaries and treasurers, or manager, if any, by (a) the company, (b)

No.	Queries	Comments

the subsidiaries of the company, (c) and any other person:—

(*i*) managerial remuneration, under Section 198 of the Act paid or payable during the financial year to the directors (including managing directors), the managing agent, secretaries and treasurers or manager, if any;

(*ii*) expenses reimbursed to the managing agent under Section 354;

(*iii*) commission or other remuneration payable separately to a managing agent or his associate under Sections 356, 357 and 358;

(*iv*) commission received or receivable under Section 359 of the Act by the managing agent or his associate as selling or buying agent of other concerns in respect of contracts entered into by such concerns with the company;

(*v*) the money value of the contracts for the sale or purchase of goods and materials or supply of services, entered into by the company with the managing agent or his associate under Section 360 during the financial year;

Note: The aggregate amount for the above, if shown separately, will be a sufficient compliance with this requirement.

(*vi*) other allowances and commission including guarantee commission (details to be given);

Note: Any reimbursement of expenses of an out-of-pocket nature will not be treated as 'allowances'.

(*vii*) any other perquisites or benefits in cash or in kind (stating approximate money value where practicable):

Note: See Explanation to Section 198 of the Act for definition of "remuneration" which includes "perquisites".

(*viii*) Pensions, etc.,—

(*a*) pensions,

(*b*) gratuities,

(*c*) payments from provident funds, in excess of own subscriptions and interest thereon,

(*d*) compensation for loss of office,

(*e*) consideration in connection with retirement from office.

No.	Queries	Comments

Explanation:

With reference to the words "detailed information" mentioned above, it would be adequate compliance if one aggregate figure is shown under each of the items (*i*) to (*vii*) and under each sub-head of item (*viii*) above, whether material or not.

Have you obtained the Board's Resolution giving full details of items (*i*) to (*viii*) above?

(B) The profit and loss account shall also contain or give by way of a note, a statement showing the computation of net profits in accordance with Section 349 of the Act with relevant details of the calculation of the commissions payable by way of percentage of such profits to the directors (including managing directors), the managing agents, secretaries and treasurers or manager, if any).

Note: The above statement is not required where no payment of remuneration based on such profits is involved.

(C) The profit and loss account shall further contain or give by way of a note, detailed information in regard to amounts paid to the auditor, whether as fee or otherwise for services rendered,

(*a*) as auditor; and

(*b*) in any other capacity.

Note: Payment made in various capacities, other than that as auditor, may be shown in the aggregate.

(D) Figures of previous year:

The comparative figures for the immediately preceding financial year or period, should also be given in the Profit & Loss Account.

PART III-SALIENT PROVISIONS OF THE COMPANIES ACT, 1956.

1. **Private Company to become Public Company in certain cases:**

Have you seen that the provisions of Section 43A, if applicable, are complied with?

2. **Investments:**

Have you ascertained that the provisions of Section 49 have been complied with?

No.	Queries	Comments
3.	**Allotment of Shares on Public Issue:** Have you ascertained that the provisions of Sections 69 to 75 are complied with?	
4.	**Underwriting Commission & Brokerage:** Have you ascertained that the provisions of Section 76 are complied with?	
5.	**Loans for Purchase of its own or its Holding Company's Shares:** Have you ascertained that the provisions of Section 77 are complied with?	
6.	**Premium received on issue of Shares:** Have you ascertained that the provisions of Section 78 are complied with?	
7.	**Issue of Shares at a Discount:** Have you ascertained that the provisions of Section 79 are complied with?	
8.	**Redeemable Preference Shares:** Have you ascertained that the provisions of Section 80 are complied with?	
9.	**Further Issue of Capital:** Have you verified that the principles embodied in Section 81 are complied with?	
10.	**Alteration of Share Capital:** Where there has been alteration of share capital during the year of audit, have you ascertained that the provisions of Sections 94 to 97 have been complied with?	
11.	**Shares Issued for consideration other than Cash:** (*a*) Have you scrutinized the contract with the vendor? (*b*) Have you inspected the Board's resolution for allotment of such shares? (*c*) Is the resolution in agreement with the contract? (*d*) Have you inspected the details stated in Prospectus or Statement in Lieu of Prospectus, if any? (*e*) Have you verified the journal entries recording such issue?	

No.	Queries	Comments
12	**Reduction of Share Capital:** Have you ascertained that the provisions of Sections 100, 101, 102 and 103 are complied with?	
13.	**Register of Charges:** Have you inspected the Company's Register of Charges as required under Section 143?	
14.	**Commencement of Business by a Public Company:** Have you ascertained that provisions of Section 149 are complied with?	
15	**Acquisition of an existing Concern:** (*a*) Where a company purchases a running business or business assets from vendors, have you scrutinized the journal entries incorporating the assets acquired and the liabilities taken over, if any, and vouched them with the contract between the Company and the Vendors? (*b*) Where the purchase consideration happens to be less than the value of net assets acquired, have you seen that the surplus accruing to the company has been treated as Capital Reserve? (*c*) Where the Company does not take over book debts from vendors but agrees to collect them on their behalf and pay off the vendor's liabilities from the proceeds realised, have you seen that such debtors' and creditors' accounts are not mixed up in the books of the Company but posted to a separate Vendors' Suspense Account? (*d*) Have you seen that the book debts collected and the liabilities paid off on behalf of the vendors are properly adjusted on the Vendors' Suspense Account? (*e*) Have you seen that any loss by way of discount or bad debts on book debts taken over for collection are charged to Vendors' Suspense Account? (*f*) Has the same procedure been followed where book debts are guaranteed by Vendors? (*g*) In all such cases, have you carefully examined the company's contract with Vendors, to ascertain the arrangements agreed upon?	
16	**Inspection of Minutes Books:** Have you gone through the Shareholders' and Directors' Minutes Books for the period of audit?	

No.	Queries	Comments
	Note: (*i*) It is advisable to scrutinize the Minutes Books of Directors' Meetings upto the date of audit, so that any subsequent development affecting the period of audit, if recorded, may not be lost sight of. (*ii*) Have you seen that the provisions of Section 193 are complied with?	
17	**Managerial Personnel:** Have you seen that the provisions of Section 197-A are complied with? (Obtain a Board's Resolution that there is no contravention of Section 197-A).	
18	**Overall Managerial Remuneration:** (Applicable only to Public Companies and those Private companies which are subsidiaries of a Public Company). Have you seen whether provisions of Section 198 have been complied with?	
19.	**Remuneration of Directors etc. (Not Applicable to Private Non-subsidiary Companies):** Have you seen whether provisions of Sections 309, 310 and 311 are complied with?	
20.	**Calculation of Commission payable to Officers and Employees:** Where the commission or other remuneration payable to any officer or employee of the Company is fixed at a percentage of, or is otherwise based on, the net profits of the Company, have you seen that such profits are calculated as laid down in Sections 349, 350 and 351 and in no other manner irrespective of any other arrangement to the contrary?	
21.	**Prohibition of Tax-Free Payment:** Have you seen that the Company has not paid any remuneration free of any tax to any Officer or employee of the Company as laid down in Section 200?	
22.	**Restriction on Appointment of Firm or Body Corporate to Office or place of Profit under the Company:** Have you seen that there has been no breach of provisions of Section 204 of the Act?	

No.	Queries	Comments

23. **Dividends:**

(*i*) Have you seen whether provisions of Section 205 have been duly complied with?

(*ii*) Before a company has declared or paid any dividend, have you ascertained that the mandatory provisions for depreciation set out in Section 205 have been complied with?

(*iii*) Have you seen that the dividend declared by the Company in general meeting does not exceed the amount recommended by the Board?

(*iv*) Have you seen that payment of any interim dividend is permitted by the Articles?

(*v*) Have you seen that before declaring any dividend, the Company has duly carried out the obligations if any, contained in the Articles, to set aside certain amounts to reserves?

(*vi*) Have you seen that all dividends have been declared according to the amounts paid or credited as paid on the shares, in respect of which the dividend is paid?

(*vii*) Have you seen that no amount paid or credited as call in advance has been treated for the purpose of (*vi*) above as paid or credited on the share?

(*viii*) Have you seen that all dividends have been apportioned and paid proportionately to the amounts paid or credited as paid on the shares, during any portion or portions of the period, in respect of which the dividend is paid except where, any share is issued on terms providing that it shall rank for dividend as from a particular date?

(*ix*) Have you seen that no dividend shall bear any interest against the Company?

24. **Payment of Interest out of Capital:**

Have you seen that the provisions of Section 208 are complied with?

25. **Books of Accounts:**

Have you seen whether provisions of Section 209 have been duly complied with?

No.	Queries	Comments

26. **Annual Accounts—Balance Sheet and Profit and Loss Account:**
Have you seen whether provisions of Sections 210, 211 and 216 have been complied with?

27. **Authentication of Accounts:**
(*a*) Have you seen whether provisions of Section 215 have been duly complied with?
(*b*) Have you forwarded a letter to Registrar of Companies showing the name and registered number of the partner who has signed the report and accounts on behalf of your firm of Chartered Accountants?
Note: As recommended by the Institute of Chartered Accountants of India, such letter should be forwarded to the Registrar within a reasonable period, say seven days of signing the report.

28. **Appointment of Auditors:**
Have you seen whether provisions of Sections 224, 225 and 226 have been complied with?
Note: Unless you are a retiring auditor, it is necessary to inform the Registrar in writing, within 30 days of the intimation by the company, of your appointment whether you have accepted or refused to accept the apointment. This applies only to appointments made at annual general meetings.

29. **Audit Report:**

(*a*) Have you seen whether provisions of Sections 227 & 229 have been complied with?
(*b*) Have you appreciated the distinction under Section 222 of the Act, regarding documents annexed and documents attached to the Accounts?
Note: 1. Auditor's signature must be appended to documents required to be annexed to the Accounts but not to those documents which are to be attached to the Report.
2. Where any of the matters referred to in clause (i) & (ii) of sub-section (2) or in clauses (a), (b), (bb) and (c) of sub-Section (3) of Section 227 is

No.	Queries	Comments

answered in the negative, or with a qualification, the auditor's report shall state the reason for the answer.

3. Where in any financial year, the accounts of the Branch Office of a Company have not been audited by an auditor mentioned in Sub-Section (1) of Section 228, the Auditor of the Company shall expressly state in the audit report, that the Branch Office is exempt from the requirements of Section 228 by virtue of Rule 3 or that an exemption has been granted under Rule 4 of the Companies (Branch Audit Exemption) Rules, 1961.

30 **Audit of Branch Office:**

Have you seen whether the provisions of Section 228 are complied with?

Note: 1. The Branch Auditor, if any, shall prepare a report on the accounts of the Branch Office examined by him and forward the same to the Company's Auditor, who shall in preparing the Auditor's report, deal with the same in such manner as he considers necessary.

2. It is suggested that the Branch Auditor shall prepare his report, as far as practicable, in the form prescribed by Section 227. He should also see that the accounts forwarded to the statutory auditor, are as far as practicable, in accordance with the requirements of Schedule VI.

31. **Directors:**

(*a*) Have you seen before passing Director's remuneration, that provisions of Section 259 and the Articles of the Company are complied with?

(*b*) Have you seen whether provisions of Sections 268 and 269 are complied with where applicable?

(*c*) Have you checked the presence of directors at Board Meetings with the help of Directors' attendance book for the purpose of passing the directors' fees?

(*d*) Where directors have resolved to make calls or

No.	Queries	Comments

to issue debentures or to borrow moneys or to invest funds of the Company or to make loans, have you seen that such powers have been exercised actually at a Board Meeting?

(*e*) Have you noted that where the company is a public company or a private subsidiary company of a public company, the Directors have not done any of the following acts without consent of the public company or subsidiary company in a General meeting:—

(*i*) Sell, lease or otherwise dispose of the whole or substantially the whole of the company's undertaking;

(*ii*) remit or give time for the repayment of any debt due by a Director;

(*iii*) Invest funds under circumstances laid down in Section 293 (1) (c);

(*iv*) borrow moneys under circumstances laid down in Section 293 (1) (d);

(*v*) make certain contributions under circumstances laid down in Section 293 (1) (e);

(*f*) Contributions to political parties.

Have you ascertained that the Provisions of Section 293-A are complied with?

32. **Appointment of Sole Selling Agents:**

Have you seen whether the provisions of Section 294 are complied with?

33. **Loans to Directors, etc.:**

Have you seen whether the provisions of Section 295 are complied with?

Note: Current accounts with Directors, etc. whether in credit or debit should be shown separately.

34. **Contracts in which Directors are Interested:**

Have you seen whether provisions of Sections 297, 299, 300 and 301 have been complied with?

35. **Office of Profit held by a Director:**

(Applicable to all Companies)

Have you seen whether provisions of Section 314 have been complied with?

No.	Queries	Comments
36.	**Managing Director's Remuneration:** (*a*) While passing the remuneration and allowances of a Managing Director of a public company or a private company which is a subsidiary of a public company, have you seen that his appointment at a time, is not made or allowed to continue for more than 5 years? (*b*) In all cases, have you scrutinised the resolution or agreement appointing the Managing Director and noted the terms regarding remuneration, etc.?	
37.	**Compensation to Director for loss of office:** Have you seen whether provisions of Sections 318, 319, 320 and 321 have been duly complied with?	
38.	**Managing Agents—General:** (*a*) While passing the remuneration of the managing agents, have you seen that their term of office has not already expired in terms of Section 328 and/or that their appointment is properly made in terms of Section 326? (*b*) Have you seen, that any variation in the terms of managing agency agreement, has been approved by the Company, in General Meeting and that before such a resolution was passed, the previous sanction of the Central Government was obtained for it? (*c*) Where there has been a termination of managing agency, have you ensured from management whether the former managing agents have claimed any charge on assets of the company in terms of Section 333? If so, have you shown this fact in the accounts or in your report? (*d*) Where a managing agent has submitted his resignation, have you seen that the accounting aspects of Section 342, have been duly complied with?	
39.	**Managing Agents' Remuneration:** (Not applicable to private Companies unless they are subsidiaries of public companies). Have you seen whether the provisions of Sections 348, 349, 350, 352, 353 and 354 have been complied with?	
40.	**Managing Agents' and Selling or Buying Agents' Contracts, etc.:**	

No.	Queries	Comments

(*a*) Where the managing agent or his associate has received any commission etc. on sale of goods or services, have you seen that the provisions of Sections 356 and 357 are duly complied with?

(*b*) Where the Managing Agent or his associate has received any payment in whatever form, except actual expenses, in respect of purchases of goods, have you seen that the provisions of Section 358, are duly complied with?

(*c*) Have you seen whether the provisions of Section 359 are duly complied with?

(*d*) Have you seen whether the provisions of Section 360 are duly complied with?

41. **Remuneration Received in Contravention:**
Where it is found that the Managing Agents have received remuneration in contravention of Sections 348 to 354 and Sections 356 to 361, have you referred to it in your report?

42. **Compensation to Managing Agents for Loss of Office:**
Have you seen whether the provisions of Sections 365 to 367 are duly complied with?

43. **Loans to Managing Agents:**
(Not applicable to Private Company which is not a subsidiary of a Public Company)
Have you seen whether provisions of Section 369 are duly complied with?
Note: Balances in current account whether in debit or credit should be shown separately.

44. **Loans etc. to Companies under the same Management: (Applicable to all companies)**
Have you seen that the Company has not made any loan, given any guarantee or provided any security in contravention of the provisions of Section 370? Have you also inspected the Register required to be kept in this regard?
Note: Provisions of sub-section (IB) regarding Companies "under the same management" should be carefully considered, where applicable.

45. **Purchase by Company of Shares, etc., of other Companies: Not applicable to:**
(*a*) any banking or insurance company;

No.	Queries	Comments

(*b*) a private company unless it is a subsidiary of a public company;

(*c*) any company established with the object of financing, whether by way of making loans or advances to, or subscribing to the capital of, private industrial enterprises in India, in any case where the Central Government has made or agreed to make to the company, a special advance for the purpose or has guaranteed or agreed to guarantee the payment of moneys borrowed by the company from any institution outside India;

(*d*) investments by a holding company in its subsidiary; or

(*e*) investments by a managing agent or secretaries and treasurers in a company managed by him or them.

Have you seen that the Company has not infringed any of the provisions of Section 372 (including restrictions on inter-Company Investments) and Section 373?

46. **Secretaries and Treasurers' Remuneration:**

(Not applicable to a private company unless it is a subsidiary of a public company)

Have you seen that the Company has not paid to its secretaries and treasurers in respect of any financial year, by way of remuneration, whether in respect of their services as secretaries and treasurers or in any other capacity, any sum in excess of 7½% of the net profits of the Company for that financial year?

47. **Manager's Remuneration:**

(Not applicable to a private company unless it is a subsidiary of a public company)

Have you seen that the remuneration paid to a Manager, either by way of a monthly payment or by way of a specified percentage of net profits of the Company or both, does not exceed 5% of the net profits of the Company as computed under Sections 349, 350 and 351? (Vide Section 387).

Note: Provisions of Sections 269, 310, 311 and 317 shall apply in relation to the Manager of a company as they apply in relation to a managing director.

No.	Queries	Comments

48. **Employees' Securities:**
Have you seen whether the provisions of Section 417 are complied with?

49. **Provident Fund:**
Have you seen whether the provisions of Section 418 are complied with?

50. **Articles of Association:**
(*a*) Have you inspected the Articles of the Company and made out a summary of the main provisions affecting Accounts, Audit, and other financial matters?
(*b*) Have there been any changes during the year in the Articles affecting the above matters?

51. **Capitalization of Profits:**
(*a*) Have you seen that it is authorised by the Articles?
(*b*) Where there has been a capitalization of profits, have you seen that the provisions in the Articles regarding capitalization of profits have been duly complied with?
(*c*) Have you inspected the sanction of the Controller of Capital Issues?
(*d*) Have you seen that due provision has been made for Bonus Tax payable if any?
(*e*) Have you obtained a copy of the resolution for your records?
(*f*) Have you seen that a proper return of allotment has been duly filed with the Registrar?

APPENDIX I

MODE OF VALUATION OF FIXED ASSETS

Attention of the members is drawn to the change made in the wording of the marginal note to the item 'FIXED ASSETS' in Schedule VI Part I by Central Government Notification No. G.S.R. 414 dated 21st March, 1961.

The marginal note now reads as under:—

"Under each head, the original cost and the additions thereto and deductions therefrom during the year, and the total depreciation written off or provided up to the end of the year to be stated.

(In every case where the original cost cannot be ascertained, without

unreasonable expense or delay, the valuation shown by the books shall be given. For the purposes of this paragraph, such valuation shall be the net amount at which an asset stood in the company's books at the commencement of this Act after deduction of the amounts previously provided or written off for depreciation or diminution in value, and where any such asset is sold, the amount of sales proceeds shall be shown as deduction)."

Prior to this amendment, the normal practice followed by companies in case where the original cost of an asset could not be ascertained, was to show such assets along with other assets under a single designation "At Cost or Book Value".

As a result of the amendment referred to above, companies and their auditors have experienced difficulty regarding the exact interpretation of the wording of the marginal note, particularly the words "For the purposes of this paragraph, such valuation shall be the *net* amount at which an asset stood in the company's books at the commencement of this Act after deduction of the amounts previously provided or written off for depreciation or diminution in value, and where any such asset is sold, the amount of sales proceeds shall be shown as deduction".

The Research Committee is of the opinion that as the law stands at present, there is no need to show separately, under each heading, the total value of assets shown at cost and the total value of assets shown at net book value. The Committee feel that the requirements of the Act would be satisfied if under each asset heading, with appropriate description, an aggregate figure is shown embodying both cost and net book value.

Illustrations:

(1) **Plant & Machinery** (31st March 1961):

	Rs
At cost and (where figures for cost or valuation are not reasonably obtainable at the net amount standing in the company's books on 1st April 1956 less sales)	12,00,000
Less: Depreciation:	4,00,000
	Rs. 8,00,000

In the above illustration, the words "net amount standing in the company's books on 1st April 1956" mean the net amount after deducting depreciation and the sale proceeds upto 1st April 1956 as per the books of accounts of the company. Items which can be identified at original cost are included at cost in the abovementioned figure of Rs. 12,00,000. It is not necessary, however, where an item of asset is a mixture of "at cost" and "at the net book value standing in the company's books on 1st April 1956" to show the two figures separately. The depreciation of Rs. 4,00,000 shown above, represents the *total* depreciation to date on plant and machi-

nery in respect of plant and machinery shown at cost, plus, depreciation written off after 1st April 1956 in respect of plant and machinery shown at net book value.

(2) **Plant & Machinery:**

At the net amount standing in the company's books on 1st April 1956 *less* sales—	Rs. 6,00,000

In this example, the presupposition is that it is not possible without unreasonable expense or delay, to extract the figures of original cost and, therefore, as permitted by the Act, the net amount standing in the company's books after deducting depreciation and sales upto 31st March 1956 has been shown in the outer column.

The position in the above example is for the first Balance Sheet after 1st April 1956. Subsequent additions, if any, will be at cost and Depreciation has to be written off on the "cost" or the "net amount" in each successive Balance Sheet.

It is permissible under the law to deduct the amount of sales proceeds from the total figure of a fixed asset, in cases where the original cost cannot be ascertained without unreasonable expense or delay. The Research Committee is of the view that such treatment is likely to distort the book value of the remaining assets particularly on account of the rise in price levels since the sale proceeds may well be considerably greater.

The management of companies should, therefore, take every possible step to ascertain the written down value with reference to the original cost for the purposes of adjustment of assets, sold or disposed of. Where this is not possible, an attempt should be made to work out a reasonably approximate figure with reference to old records and in such cases, the adjustment should be made with reference to such figures. In those cases where even such approximate written down values cannot be determined owing to the asset being very old, the asset may be considered as fully written off or the sales proceeds may be shown as a deduction from the book value of the block of assets concerned as permitted by law. However, before making any such adjustment on the basis of the sales proceeds, due consideration should be paid to the following factors:

(*a*) If there are good reasons to believe that the sale price contains a large element of profit, an attempt should be made to isolate such profit component even on an approximate basis before making the adjustments;

(*b*) If on the other hand, there are good reasons to believe that there is a shortfall, the approximate amount of such shortfall should be written off in the year in which the asset is sold or disposed of.

The above recommendations should, therefore, be borne in mind for the purposes of presentation of the final accounts of companies.

APPENDIX II

SCHEDULE OF FIXED ASSETS ATTACHED TO AND FORMING PART OF THE BALANCE SHEET AS AT——

	BLOCK				DEPRECIATION					
ASSETS	At Cost as on 1-1-1961 (items marked 'asterisk' are partly at Cost and partly at net Book Value as on 1-4-1956)	Additions during the year at Cost	Sub-Total	Cost of Sales and proceeds of sales etc., during the year	Total to 31-12-61	Depreciation to 31-12-1960	Deduction on account of sales etc.	For 1961	Depreciation to 31-12-1961	Net Book Value of Assets on 31-12-1961
	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.
1. Land	1,18,602	—	1,18,602	—	1,18,602	—	—	—	—	1,18,602
	(1,18,602)	—	(1,18,602)	—	(1,18,602)	—	—	—	—	(1,18,602)
2. Buildings	38,01,133	—	38,01,133	—	38,01,133	21,82,470	—	89,412	22,71,882	15,29,251
	(37,54,231)	(46,902)	(38,01,133)	—	(38,01,133)	(20,59,419)	—	(1,23,051)	(21,82,470)	(16,18,663)
3. Mill	9,45,253	—	9,45,253	—	9,45,253	3,88,241	—	20,231	4,08,472	5,36,781
Chawls	(9,45,253)	—	(9,45,253)	—	(9,45,253)	(3,67,072)	—	(21,169)	(3,88,241)	(5,57,012)
4. Machinery*	1,08,25,700	13,51,003	1,21,76,703	25,531	1,21,51,172	74,04,548	20,757	7,11,295	80,95,086	40,56,086
	(88,64,470)	(20,08,272)	(1,08,72,742)	(47,042)	(1,08,25,700)	(65,38,237)	(41,221)	(9,07,492)	(74,04,548)	(34,21,152)
5. Furniture & Fixtures*	1,34,291	13,662	1,47,953	1,145	1,46,808	35,008	620	7,424	41,812	1,04,996
	(1,29,493)	(4,798)	(1,34,291)	—	(1,34,231)	(28,498)	—	(6,510)	(35,008)	(99,283)
6. Motor Car &	1,49,259	—	1,49,259	—	1,49,259	1,03,056	—	8,754	1,11,810	37,449
Trucks	(1,62,259)	—	(1,62,259)	(13,000)	(1,49,259)	(81,369)	(2,708)	(24,395)	(1,03,056)	(46,203)
7. Live	400	—	400	—	400	50	—	—	50	350
Stock	(500)	—	(500)	(100)	(400)	(50)	—	—	(50)	(350)
Total Rs.	1,59,74,638	13,64,665	1,73,39,303	26,676	1,73,12,627	1,01,13,373	21,377	8,37,116	1,09,29,112	63,83,515
	(1,39,74,808)	(20,59,972)	(1,60,34,780)	(60,142)	(1,59,74,638)	(90,74,695)	(43,929)	(10,82,607)	(1,01,13,373)	(58,61,265)

Note: The figures given horizontally in brackets indicate previous year's amounts.

APPENDIX III

Schedule 3 Forming Part of the Balance Sheet

FIXED CAPITAL EXPENDITURE

Description of Assets	AT COST					DEPRECIATION						
	To 31st December 1960	Additions during the year	Sub-Total	Deductions during the year	Gross Block as at 31st December 1961	To 31st December 1960	Deductions during the year	Sub-Total	For the year 1961	To 31st December 1961	Balance as at 31st December 1961	1960
	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.
Freehold land	8,37,922	10,000	8,47,922	—	8,47,922	80,554	—	80,554	—	80,554	7,67,368	7,57,368
Buildings	89,19,867	2,50,327	91,70,194	—	91,70,194	79,42,522	—	79,42,522	*2,81,828	82,24,350	9,45,844	9,77,345
Tanks & Permanent Works	16,368	—	16,368	—	16,368	—		—	—	—	16,368	16,368
Machinery	2,49,41,802	7,10,157	2,56,51,759	1,59,474	2,54,92,285	1,89,94,086	1,56,140	1,88,37,946	12,61,047	2,00,98,993	53,93,292	59,47,516
Furniture & Fittings	10,10,496	85,163	10,95,659	—	10,95,659	4,42,414	—	4,42,414	1,00,817	5,43,231	5,52,428	5,68,082
Vehicles	3,22,030	42,351	3,64,381	12,321	3,52,060	1,83,467	12,321	1,71,146	91,094	2,62,240	89,820	1,38,563
Rs.	3,60,48,285	10,97,998	3,71,46,283	1,71,795	3,69,74,488	2,76,43,043	1,68,461	2,74,74,582	*17,34,788	2,92,09,368	77,65,120	84,05,242
For the Year 1960 Rs.	3,39,77,434	21,40,977	3,61,18,471	70,186	3,60,48,285	2,60,70,021	40,700	2,60,29,321	16,13,722	2,76,43,043	84,05,242	

*Includes an amount of Rs. 2,45,456 transferred during the year from Provision for Workpeoples Housing.

APPENDIX B

STATEMENTS ON AUDITING

1. *GENERAL PRINCIPLES OF AUDITING*

Auditing is an important professional task carrying heavy responsibility and calling for commensurate skill and judgment. Each auditor must decide for himself the nature and extent of the work which is necessary in order to enable him to discharge the responsibility he has undertaken, whether under statutory provisions or by arrangement with his client.

The Council of The Institute of Chartered Accountants in England and Wales considers however that it can assist the members of the Institute by issuing for their guidance a series of Statements on Auditing of which this is the first.

This Statement is related primarily to audits under the Companies Act 1948. *Other audits must be considered in the light of the relevant circumstances and statutory provisions (if any) but much of this Statement,* particularly in relation to audit procedure, should be adaptable to those *audits.*

In relation to matters of law this Statement has been settled in consultation with counsel.

INTRODUCTION

1 Auditors under the Companies Act 1948 have specific duties laid upon them and they have an obligation to acquaint themselves with those duties. Their statutory duties cannot be limited by agreement with the members or directors of the company; and Section 205 of the Act renders void any provisions, in the articles or otherwise, purporting to exempt an auditor from or indemnifying him against any liability which by virtue of any rule of law would otherwise attach to him in respect of any negligence, default, breach of duty or breach of trust in relation to the company. On the other hand, additional duties and responsibilities may be placed upon auditors by the articles of the company or by special aggrement with the members or directors. This may be particularly important where the auditors carry out other work in addition to their statutory duties as auditors. These circumstances are referred to later in paragraphs 30 and 31.

2 As a general statement of the degree of professional competence required of an auditor, reliance can properly be placed on the observation made by Lord Justice Lopes in *In re Kingston Cotton Mill Co. Ltd.** ([1896] 2 Ch. 279 at pages 288-90):

"It is the duty of an auditor to bring to bear on the work he has to

* Certain of the rulings made by Lord Justice Lopes on the particular facts of the case before him in 1896 would now be inappropriate in the light of the statutory duties imposed by the Companies Act 1948.

perform that skill, care, and caution which a reasonably competent, careful, and cautious auditor would use. What is reasonable skill, care and caution must depend on the particular circumstances of each case... If there is anything calculated to excite suspicion he should probe it to the bottom; but in the absence of anything of that kind he is only bound to be reasonably cautious and careful.... The duties of auditors must not be rendered too onerous. Their work is responsible and laborious, and the remuneration moderate...."

3 In the previous year similar judicial guidance on the duty of an auditor had been given by Lord Justice Lindley in *In re London and General Bank* ([1895] 2 Ch. 673 at page 683):

"He must be honest—that is, he must not certify what he does not believe to be true and he must take reasonable care and skill before he believes that what he certifies is true. What is reasonable care in any particular case must depend upon the circumstances of that case."

4 The foregoing comments on the auditors' position in law are a necessary background to any consideration of the duties of auditors, but this Statement is concerned essentially with the general principles of auditing as a professional assignment rather than with the consequences in law of a failure by auditors to discharge their duties. The Council's object in issuing this Statement is not to define the liability in law for such a failure. Its object is to assist members to improve the standards of auditing for the good of the profession and the benefit of their clients and the public.

5 Responsibility for the accounts and financial control of a company rests upon the directors. Their statutory duties include responsibility for ensuring the maintenance of adequate records and the preparation of annual accounts showing the true and fair view required by the Act. They are responsible for safeguarding the assets of the company and are not entitled to rely upon the auditors to protect them from any shortcomings in carrying out their responsibilities.

6 Auditors have their own independent responsibility to form and express their professional opinion on the accounts to be presented by the directors to the shareholders. Auditors do not guarantee or certify the accounts, but their responsibility is heavy and cannot be discharged without a full realisation of the professional skill and judgment which need to exercised in carrying out their duties. They must approach their work as auditors with an independent outlook and must do nothing which would impair that independence.

7 If the directors have carried out their duty properly the detailed checking by the auditors will be limited to appropriate tests which, if suitably planned, may extend to only a small proportion of the total transactions unless the company is a small organisation in which the scope for internal control is limited. If on the other hand the directors have not carried out their duty properly this will have a material bearing on the terms of the auditors' report and may well involve the auditors in extensive checking, at the expense of the company; but it is not their function to act as a substitute for proper management control.

8 The essential features of an audit are:

(*a*) to make a critical review of the system of book-keeping, accounting and internal control

(*b*) to make such tests and enquiries as the auditors consider necessary to form an opinion as to the reliability of the records as a basis for the preparation of accounts

(*c*) to compare the profit and loss account and balance sheet with the underlying records in order to see whether they are in accordance therewith

(*d*) to make a critical review of the profit and loss account and the balance sheet in order that a report may be made to the members stating whether, in the opinion of the auditors, the accounts are presented and the items are described in such a way that they show not only a true but also a fair view and give in the prescribed manner the information required by the Act.

9 The auditors should aim to reduce their detailed checking to the minimum consistent with the system of internal control and the state in which they find the records. If their enquiries and tests satisfy them that the system is sound in principle and is carried out in practice then no useful purpose is served by extensive detailed checking. If on the other hand the system is not sound or is not properly carried out then the auditors must first reach a conclusion as to the nature of the shortcomings before they can decide upon the nature and extent of the detailed checking which they should undertake. Auditors should therefore direct their attention in the first instance to the system of internal control.

INTERNAL CONTROL

Ascertaining the system

10 By 'internal control' is meant not only internal check and internal audit but the whole system of controls, financial and otherwise, established by the management in order to carry on the business of the company in an orderly manner, safeguard its assets and secure as far as possible the accuracy and reliability of its records.

11 Auditors will find it of great advantage to have before them an up-to-date record of the system of internal control. For this purpose they will normally need to make a study of the following matters:

(*a*) the characteristics of the company's business and its activities, involving possibly an inspection of its physical assets and operations

(*b*) the system of book-keeping and accounting

(*c*) the duties of the executive directors and staff and the division of responsibilities

(*d*) the system of internal check, that is to say, the checks on the day-to-day transactions which operate continuously as part of the routine

system whereby the work of one person is proved independently or is complementary to the work of another, the object being the prevention or early detection of errors and fraud; it includes matters such as the delegation and allocation of authority and the division of work, the method of recording transactions and the use of independently ascertained totals against which a large number of individual items can be proved

(*c*) internal audit, if any; where there is an internal audit the auditors should have regard to the Council's NOTES ON THE RELATION OF THE INTERNAL AUDIT TO THE STATUTORY AUDIT.

On the first occasion this study of the system will require extensive enquiry and the auditors may find it helpful to prepare for this purpose a comprehensive questionnaire, the answers to which will provide them with a basis for their record. 12

Examining the system

An examination of the system of internal control will enable the auditors to decide whether they can regard it as satisfactory. Of particular importance is the extent to which the system ensures that the division of work and allocation of responsibility are such that each of the following aspects of the company's activities is sufficiently independent of the others: 13

(*a*) the transacting of business (that is to say, the creation of contractual obligations and of any original record thereof)
(*b*) the recording of those transactions in the books and records
(*c*) the custody and handling of the assets involved in the transactions.

A large company should have a comprehensive system of internal control. A smaller company, having less opportunity for division of responsibilities and the institution of internal checks, may have a system which is less comprehensive without necessarily being unsatisfactory. This is a matter upon which the auditors must exercise their judgment. The directors of every company, irrespective of its size, have a duty to ensure that there is a proper system of control over the transactions and records and that proper arrangements are made for safeguarding the company's assets. There will usually be some respects in which the possible errors or losses to the business are not sufficiently material to justify the additional expense which would be incurred by extending the control system sufficiently to prevent them. 14

Apart from the work which the auditors should themselves do if they encounter weaknesses in the system of internal control (as indicated in later paragraphs) it is good practice for them to advise a director or appropriate executive, preferably in writing, with the object of assisting the directors in the discharge of their obligation to control and safeguard the assets of the company. 15

THE NATURE AND EXTENT OF THE TESTS TO BE APPLIED

16 Audit procedures should be based primarily on an appropriate series of tests designed to satisfy the auditors that the system of internal control is properly operated and is effective, so that the records can be regarded as a reliable basis for the preparation of accounts. Tests of the detailed transactions should be reduced to the minimum considered necessary by the auditor to achieve this purpose and unnecessary expenditure of time on the massive vouching of routine transactions and extensive verifications of postings and additions should be avoided.

17 The nature and extent of the tests which the auditors apply will vary according to the strength or weakness of the system of internal control and the nature of the internal checks which exist as well as according to the type of transaction or item which is the subject of examination. It is important to include examinations 'in depth' among the tests to be applied. Examination 'in depth' involves tracing a transaction through its various stages from origin to conclusion, examining at each stage to an appropriate extent the vouchers, records and authorities relating to that stage and observing the incidence of internal check and delegated authority. For example, verification of a payment to a creditor for goods supplied could be made by examination of a paid cheque which had been drawn in favour of the creditor and crossed 'Account payee only'. Complete verification of this transaction 'in depth' might involve the examination of the transaction at all stages including the following documents or records:

(*a*) the invoice and statement from the supplier
(*b*) evidence that the goods had been recorded in the stock records
(*c*) the goods received note and inspection certificate
(*d*) a copy of the original order and the authority therefor.

18 It is sound practice to reduce progressively the number of transactions selected for examination as the depth of the examination increases. For example, it might, in a particular case, be appropriate for the auditors to select one hundred payments to creditors for goods supplied and verify them by examination of the paid cheques properly crossed and stamped by the paying bank; only a proportion of those one hundred payments would also be verified with the suppliers' invoices and statements; a still smaller proportion would be verified in addition by evidence that goods had been recorded in the stock records; and so on until a comparatively small proportion had been verified completely in depth.

19 For a small company the tests which the auditors make will normally cover a greater proportion of the transactions than is necessary for a larger company where a more comprehensive system of control can be and is operated. In selecting items for examination and deciding upon the extent of the work to be done the auditors should always consider to what extent the transactions under review are material in relation to the affairs of the company as a whole.

In addition to the normal annual audit procedures covering all activities, it is also sound practice to select each year, for a more intensive review of the accounting procedures, one of the main aspects of the activities of the business: for example, sales, wages, receipts from customers, payments to suppliers. Such reviews can usefully be planned to ensure that over a period of years they cover all the main aspects. 20

Depending on the circumstances it may or may not be necessary for the auditors to extend their tests in certain areas because of deficiencies in the system of internal control. Where, however, the auditors are of opinion that the internal control is inadequate to the extent of casting doubt on the reliability of the records, they will be obliged to undertake a great deal more detailed checking than would otherwise have been necessary. If, even after extensive detailed checking, they have been unable to satisfy themselves that the records are sufficiently reliable to enable the balance sheet and profit and loss account to show the true and fair view required by law, it will be their duty to state in their report that in their opinion books of account have not been properly kept and to make such other reservations as may be necessary. 21

In exceptional cases, auditors may find that the records and the system of internal control are so seriously inadequate that no useful purpose could be served by embarking upon extensive detailed checking, because even the most exhaustive tests would not enable them to form an opinion on the balance sheet and profit and loss account. In that event their appropriate course will be to report to that effect to the shareholders and to inform the directors of the respects in which the records and system are deficient. 22

EXAMINATION OF THE PROFIT AND LOSS ACCOUNT AND BALANCE SHEET

The auditors will compare the profit and loss account and balance sheet with the books and records in order to see whether they are in accordance therewith. 23

In addition, the auditors will make a critical review of the profit and loss account and balance sheet in relation to the following matters: 24

(*a*) whether the accounts have been prepared on sound accounting principles consistent with those applied in the previous period; the distinction between capital and revenue is particularly important to prevent the overstatement of profits by charging revenue expenditure to capital or their understatement by charging capital expenditure to revenue

(*b*) the items in the balance sheet, with particular reference to the basis on which and the amounts at which they are stated and:

  (*i*) the existence, ownership and proper custody of assets

  (*ii*) the existence of liabilities

  (*iii*) their relation to the corresponding items at the end of the previous year, and, where necessary, earlier years

(*iv*) the suitability of the descriptions used
(*v*) an adequate disclosure of information

(*c*) the items in the profit and loss account with particular reference to adequate description, disclosure of information and the significance of variations as compared with previous periods
(*d*) compliance with the requirements of the Act.

25 The purpose of the work of the auditors is to enable them to express an opinion as to whether the accounts presented to the members show a true and fair view. This purpose should govern their whole approach to the audit, the planning of their tests and the matters to be noted in the audit papers as the work proceeds. If they find weaknesses or matters which arouse their suspicion they should make exhaustive enquiries and if in any material respects they are unable to satisfy themselves it will be their duty to include appropriate reservations in their report, to the extent, it necessary, of stating that they are not able to express the opinion that the accounts show a true and fair view.

FRAUD

26 Irregularities which arise in the conduct of the affairs of a company may be classified broadly into:

(*a*) acts or defaults by an employee or a director which are committed without the knowledge of the board of directors; it is the responsibility of the directors to take all reasonable care that the system will prevent such irregularities or bring about their early detection
(*b*) acts or defaults by the directors which are designed to mislead or defraud the members
(*c*) acts or defaults designed to defraud the Inland Revenue or other third parties (on which the Council has already issued its statement entitled UNLAWFUL ACTS OR DEFAULTS BY CLIENTS OF MEMBERS).

27 Material irregularities of the above character will normally be brought to light by sound audit procedures but there is nothing in the Companies Act 1948 which specifically places a duty upon auditors to search for them or to examine the books and accounts with the object of discovering whether there have been defalcations or other irregularities by directors or employees of the company. Lord Justice Lopes pointed out in the *Kingston, Cotton Mill* case:

"Auditors must not be made liable for not tracking out ingenious and carefully laid schemes of fraud, when there is nothing to arouse their suspicion, and when those frauds are perpetrated by tried servants of the company and are undetected for years by the directors. So to hold would make the position of an auditor intolerable."

Although there is no statutory obligation upon the auditors to search for irregularities, the possibility of their existence will be a factor governing the auditors' approach to their work as described in paragraph 9 and in discharging their statutory duties. In normal circumstances they are entitled to rely upon the honesty of the directors and employees of the company. But if, in the course of their examination, their suspicions are aroused they have a clear duty to probe the circumstances to the bottom and to report appropriately to the members. 28

AUDITORS' REPORT

The auditors' report is governed by the requirements of the Ninth Schedule to the Act. They should express their opinion in clear and unequivocal terms. If they are unable to satisfy themselves on any of the matters referred to in the Ninth Schedule they must include appropriate reservations in their report to the members of the company. They are not relieved of this obligation by making a report to the directors even though the directors may comprise all the members of the company. 29

OTHER DUTIES UNDERTAKEN BY AUDITORS

Accountants acting as auditors of a company frequently provide other professional services for the company. In particular they may draft for the directors the balance sheet and profit and loss account and sometimes assist with the underlying records; and they may at the request of the directors undertake detailed checking beyond that which is required to enable them to make their report to the shareholders, for example checking with the specific object of ascertaining whether there have been defalcations or other irregularities. In doing work of this kind they are not acting as auditors appointed under the Act but are rendering a separate professional service. Such additional services may facilitate their work in their capacity as auditors but do not extend or reduce the responsibilities placed upon them as auditors by the Act. 30

Where such additional services are rendered the following are important considerations: 31

(*a*) the accountants should not undertake services which would impair their independence as auditors

(*b*) the duty to take all reasonable care that there is adequate internal control and to present accounts to the shareholders in compliance with the Act rests firmly on the directors and cannot be avoided by them

(*c*) there should be a clear understanding with the directors as to the nature of the responsibility undertaken by the accountants outside their duty as auditors, so that there is no misunderstanding as to the extent to which the directors, in discharging their own responsibilities,

are placing reliance upon the additional services provided by the accountants.

2. *STOCK-IN-TRADE AND WORK IN PROGRESS*

As was pointed out in Statement No. 1, *GENERAL PRINCIPLES OF AUDITING, a general statement of the degree of professional competence required by law of an auditor is to be found in the judgment of Lord Justice Lopes in the case of* In re Kingston Cotton Mill Co. ([1896] 2 *Ch.* 279) *where it was thus expressed*:

"It is the duty of an auditor to bring to bear on the work he has to perform that skill, care and caution which a reasonably competent, careful and cautious auditor would use. What is reasonable skill, care and caution must depend on the particular circumstances of each case.... If there is anything calculated to excite suspicion he should probe it to the bottom but in the absence of anything of that kind he is only bound to be reasonably cautious and careful...."

This broad statement is no doubt still a valid exposition of the legal test applicable in general; but it has been widely recognized for many years that it does not give sufficient detailed guidance to auditors on the steps which are appropriate for them to take before accepting as valid the amount at which stock-in-trade and work-in-progress are stated in the balance sheet. This item presents many difficulties for auditors and accordingly the Council of The Institute of Chartered Accountants in England and Wales issues this Statement for the guidance of members in determining their audit procedure. It relates primarily to company audits but the considerations outlined apply equally to other audits which involve consideration of stock-in-trade, subject to any statutory provisions or instructions governing the scope of such audits.

The examinations and tests indicated in this Statement are not exhaustive. Alternative or additional steps may be necessary according to circumstances. Some paragraphs may imply a degree of organisation or control normally found only in large or medium-sized businesses, but the underlying principles apply to companies irrespective of their size and the extent of internal control in operation.

GENERAL DUTY OF AUDITORS

1 It is still true, as was established by the Kingston Cotton Mill case, that it is no part of the auditors' duty to take stock, but this does not mean that auditors have no duty in relation to stock.

2 In the Kingston Cotton Mill case, the auditors passed accounts in which the stock-in-trade was grossly overstated, but they did so honestly in reliance upon certificates as to stock-in-trade given by a director who was also manager and a man of acknowledged competence and high reputation and trusted by the other directors. The manager's certificates were in

fact wilfully false. The auditors were exempted from liability. If they had suspected the genuineness of the certificates (which they did not) the auditors could have detected the fraud by reconciling the changes in stock quantities as between the beginning and end of the financial year with the purchases and sales records; having no such suspicion, they did not do so.

Since the Kingston Cotton Mill case there have been two important developments to which in the opinion of the Council auditors should now have regard, namely:

(*a*) the duties of auditors have been extensively defined by the Companies Act, 1948, Section 162 and the Ninth Schedule, in terms which were no part of the law in 1896 and which make some of the observations of the Court of Appeal in 1896 as to the duties of auditors inappropriate

(*b*) there have been great improvements both in the standards of company accounting and in the standards of auditing.

This Statement is therefore issued by the Council for the assistance of members in carrying out their duties as auditors.

Essentially, the duty of the auditors of a company is to arrive at an independent professional opinion on whether the directors have properly carried out their own duties in the preparation of accounts for presentation to shareholders. The directors have a statutory duty to take all reasonable steps to secure compliance with the requirements of the Companies Act 1948 regarding the keeping of proper books of account and the presentation of annual accounts showing the true and fair view required by the Act. In relation to stock-in-trade and work-in-progress it is therefore the directors' responsibility to ensure that:

(*a*) the physical quantities owned by the company are properly ascertained and recorded

(*b*) the condition is properly judged

(*c*) the amount to be carried forward in the balance sheet has been properly determined on an appropriate basis or appropriate bases by suitable methods.

In order to reach an opinion on whether the directors have properly discharged that responsibility the auditors will need to: 5

(*a*) ascertain the procedure which has been adopted

(*b*) consider whether that procedure is sound, having regard to the particular circumstances of the company

(*c*) test the competence with which the procedure has been carried out.

It is a usual and desirable practice to obtain from a director or other responsible official of the company a stock certificate at each balance 6

sheet date. This provides the auditors with a formal statement by the responsible official in support of the amount at which stock is stated in the accounts. Such a certificate does not relieve the auditors of their duty to decide, by means of appropriate tests, whether they can properly reach the opinion that the directors have in fact discharged their responsibility

ASCERTAINMENT OF THE COMPANY'S PROCEDURE

7 The manner in which the auditors will ascertain the procedure which has been adopted will depend on the circumstances of the company. Large organisation will usually have written instructions to which the auditors have access. Smaller concerns may issue oral instructions or may rely on the routine established for many years; the auditors of such a company should enquire of the individuals concerned as to the procedure which is followed and prepare their own notes thereon.

8 Enquiries may be facilitated by the use of a questionnaire, which can be completed either by the company or the auditors. Alternatively a short list of essential points may be used as an *aide-mémoire* in discussion with the company's officials.

CONSIDERATION OF THE COMPANY'S PROCEDURE

9 The ascertainment of stock quantities is a physical operation and may be by means of an annual stocktaking, without supporting records, or by a periodical or continuous comparison of stock records with actual stock. The essential operations involved in ascertaining the quantities to be taken into account are:

(*a*) identification of the articles and their ownership
(*b*) counting, weighing or measuring them
(*c*) recording the information.

Methods of carrying out those operations will vary according to the size and circumstances of the business and the nature of its stock records. In planning their work the auditors will need to assess the effectiveness of the procedure adopted in the business.

10 Experience shows that it may be desirable for the auditors to make their assessment of the company's procedure and to give consideration to the basis on which stock is to be included in the accounts well in advance of the balance sheet date. This may enable them to suggest improvements which will benefit the company by preventing difficulties which would otherwise emerge at a later stage and might be capable of being resolved only with considerable trouble and expense, if at all. Such improvements will also facilitate the work of the auditors in their subsequent testing of the procedure. Some considerations which are relevant in making this assessment are indicated in paragraphs 11 to 16 below.

Quality of staff

Is the stocktaking performed carefully and systematically by persons fully informed of the duties involved? 11

Independence of staff

Is the stocktaking carried out by or under the supervision of persons who do not also have charge of stock-keeping? 12

Stock records

Where stock records are kept (as distinct from the making of an annual inventory without supporting stock records) the auditors will be concerned with such questions as: 13

(*a*) are the records kept accurately and up to date?
(*b*) are the physical quantities checked against the records at the year end, or continuously throughout the year?
(*c*) where the checking is continuous, is it done systematically either by an appropriate spread over the year or by choosing times which may reduce the work and risk of error (for example, when stocks are at their lowest, either seasonally or individually)?
(*d*) is the checking so planned that each category of stock is checked at least once a year?
(*e*) what is the procedure for investigating the causes of differences revealed on checking and for amending the records?
(*f*) are the methods of recording and control of stocks such that unexplained differences are kept within reasonable limits?

Work in progress

Physical checking of work in progress will often not be possible by methods similar to those adopted for unused stocks. Reference to costing records is frequently necessary and it may not be possible to separate the question of physical quantity from the question of the amount to be attributed to the work-in-progress. Where it is not possible or practicable to identify the work-in-progress with either the components which have gone into it or the products which will emerge from it, the auditors will be concerned with such questions as: 14

(*a*) what is the costing system from which the work-in-progress is ascertained?
(*b*) is the costing system reliable and in particular is it integrated with the financial accounting?
(*c*) to what extent are checks made by reference to statistical information concerning outputs of main products and of by-products (if any) which ought to be obtained from materials used?
(*d*) what is the system of inspection and reporting thereon to enable

allowance to be made in the costing records for scrapping and rectification?

*(e) what is the basis on which overheads are dealt within the costing records?

(f) is any profit element included for which adjustments are required? (*See also paragraph 22.)

'Cut-off' procedure

15 To ascertain the stock-in-trade and work-in-progress at the balance sheet date requires suitable 'cut-off' arrangements, that is to say arrangements which will ensure that at the relevant point of time there is complete accord between the physical stock which is brought into account, the records of the physical movement of stock and the related financial records of purchases and sales and of debtors and creditors. On this aspect the auditors will be concerned with such question as:

(a) what is the procedure for linking sales records with stock records, so that goods invoiced to customers are not included in the stock even though still held?

(b) what is the procedure for linking purchase records with stock records, so that the purchase of all goods taken into stock is recorded and all goods purchased are included in the stock, whether held on the company's premises or elsewhere?

(c) where the stocktaking is by annual inventory without supporting stock records and the whole or any part of the stocktaking was carried out before or after the balance sheet date, what is the procedure for adjusting the inventory to take account of movements in and out between the stocktaking date and the balance sheet date?

(d) if the nature of the business involves holding goods belonging to others (for example, goods on consignment or customers' own goods awaiting processing) what is the procedure for ascertaining that such goods are not included in the inventory?

Condition of stock

16 Stock which is slow moving, obsolete or damaged requires consideration by a responsible official in order to determine its treatment in arriving at the amount at which stock is to be stated in the balance sheet. The auditors will therefore be concerned with questions such as:

(a) what is the procedure for ascertaining and recording the condition of stock and for reviewing the rate of turnover?

(b) who is responsible for considering the results of that procedure and for determining the basis on which slow moving, obsolete or damaged stock is to be stated in the accounts?

AUDIT TESTS OF THE COMPANY'S PROCEDURE

Audit tests of the company's procedure will be planned in the light of the auditors' assessment of its soundness in principle and with the object of enabling them to form an opinion on whether the procedure is properly operated and is effective. An appropriate series of tests will be based on the considerations referred to in the following paragraphs. 17

Ascertainment of physical quantities and ownership

Appropriate audit tests will include all or some of the following as the auditors may decide: 18

(*a*) examination of the count sheets (including 'rough' sheets where these have been copied to new sheets) where there is only an annual stock-taking unsupported by stock records; this examination will extend to the adequacy with which the items have been described to enable them to be identified for subsequent steps such as pricing and assessment of condition

(*b*) examination and testing of continuous stock records, where these are kept; this examination will be designed to test the reliability of the records and will include consideration of the results of actual counts, the extent to which differences have arisen as compared with the records and the manner in which those differences have been recorded and investigated

(*c*) examination and testing of the links between purchase records and stocks and between sales records and stocks, with the object of testing the operation of the 'cut-off' procedure (paragraph 15)

(*d*) examination of records of stocks belonging to the company but held by others (for example, stocks overseas, or on consignment, or with outside warehousemen) and consideration of the appropriateness or otherwise of the quantities involved being in the hands of the bailees concerned; where significant quantities are so held the records to be examined will include reports on inspections made by the company's staff and the certificates from the bailees, with particular attention to any reservations by the bailees indicating that they do not accept responsibility for the accuracy with which the nature and/or quality of the stock are described

(*e*) general scrutiny of the inventory or the stock records (and comparisons with the previous year) including attention to the possibility of material omissions or the inclusion of items such as loose tools which ought not to be included because they appear elsewhere in the accounts

(*f*) where applicable, tests by reference to statistical information covering matters such as yields which may be expected from given quantities and normal losses or gains by evaporation or absorption of moisture

(*g*) in relation to work-in-progress, examination and testing of available records including costing records and work tickets attached to un-

finished articles and, where there are long-term contracts, examination of the relevant contracts including any modifications thereof and other information such as subsequent cost reports and estimates of costs to complete

(*h*) general scrutiny of records for appropriate initials and signatures indicating responsibility for the work which has been carried out by the company's staff.

Age and condition of stock

19 Where stock is defective (through faulty manufacture or deterioration during storage) or is obsolete or unduly slow moving, these factors must be taken into account in determining the amount at which stock is stated in the balance sheet. Appropriate audit tests of the company's procedure for judging the physical condition will normally include:

(*a*) scrutiny of stock records during the tests referred to in paragraph 18, to ascertain what information as to condition and slow moving stocks has been recorded and what action has been taken on that information

(*b*) comparison with the stock records relating to the previous balance sheet date

(*c*) examination by reference to normal experience of wastage due to rejects and deterioration

(*d*) examination of the relationship between stocks and turnover, including consideration of current trading conditions and any changes in sales or stockpiling policies

(*e*) discussion with the management.

Attendance to observe stocktaking

20 Where the auditors consider that such a step would be of assistance to them in the performance of their duties and would be reasonable and practicable in the circumstances, they may attend occasionally at one or more of the locations to observe the actual stocktaking, whether the stocktaking is done periodically or on a continuous basis. This may be particularly helpful in the first year in which the audit is undertaken and thereafter from time to time, particularly when there have been changes in the procedure or where there are no stock records other than the annual inventory. Such observation by auditors will enable them to consider whether the stock checkers are complying with the procedure laid down and whether it is adequate for internal control purposes. During such observation the auditors may consider it desirable to test some of the counts made by the company's officials.

21 When the auditors decide to attend to observe stocktaking on the lines indicated above they should avoid misunderstanding by making clear to the management the reason for any such attendance. The presence of auditors at stocktaking does not relieve the management in any way of

their responsibilities. The auditors are neither stocktakers nor valuers nor have they any responsibility for supervising the stocktaking. Their presence is to enable them as auditors to consider the adequacy and effectiveness of the procedure. They will however be ready to advise or make recommendations, just as they would on other matters when they consider that the system of control is weak or is not being properly carried out.

Amount at which stock is stated

Audit procedure will be designed to ascertain whether the amount at which stock-in-trade and work-in-progress are stated has been computed on a basis (or bases) and by methods which, consistently applied and having regard to the nature and circumstances of the business, will enable the accounts to show a true and fair view of the trading results and the financial position. The accounting principles involved are dealt with in Recommendation 22, TREATMENT OF STOCK-IN-TRADE AND WORK-IN-PROGRESS IN FINANCIAL ACCOUNTS. 22

After examining the principles adopted by the management, the audit procedure to test the application of those principles will normally include: 23

(*a*) tests of the stock sheets or continuous stock records with relevant documents such as invoices, costing records and other sources for the ascertainment of 'cost'

(*b*) examination and testing of the treatment of overhead expenses

(*c*) tests of 'net realisable value' (or, as the case may be, 'replacement price') with current selling prices and current buying prices and other relevant information including changes in prices since the balance sheet date so far as the information is of assistance in determining the net realisable value in the ordinary course of business on the balance sheet date

(*d*) tests of the arithmetical accuracy of the calculations

(*e*) tests of the consistency, in principle and in detail, with which the amounts have been computed

(*f*) consideration of replies to the enquiries which the auditors make of the company's officials

(*g*) consideration of the adequacy of the description applied to stock-in-trade and work-in-progress in the balance sheet.

Scope of the audit tests

The volume and nature of the tests which the auditors will need to do on the lines indicated in paragraphs 18 to 23 above are matters on which the auditors must use their own judgment in the light of their professional experience and having regard in particular to the nature of the business, the state of the records and their assessment of the soundness of the company's procedure. 24

25 For small companies where the facilities for internal control are necessarily restricted and for any company whose procedure is unsatisfactory the auditors will need to extend their tests beyond what would otherwise have been necessary. For all businesses however it is important that the auditors should have regard to the significance of the amounts involved in relation to the accounts as a whole so that time is not spent unecessarily on extensive tests of items which cannot in any event have a material bearing on the presentation of a true and fair view.

26 Where applicable, having regard to the nature of the business, the tests will include examination 'in depth' (see paragraphs 17 and 18 of Statement No. 1, GENERAL PRINCIPLES OF AUDITING).

Overall tests

27 Audit tests which may often be appropriate by way of overall assessment of the reliability of the records will include, according to circumstances:

(*a*) reconciliation of changes in stock quantities as between the beginning and end of the financial year with the records of purchases, production and sales

(*b*) comparison of the quantities and amounts of stocks in the various categories with those included at the previous balance sheet date and with current sales and purchases

(*c*) consideration of the gross profit ratio shown by the accounts and its comparison with the ratio shown in the previous years

(*d*) consideration of the rate of turnover of stocks and its comparison with previous years

(*e*) consideration of the relationship of the quantities ready for sale and in course of production with the quantities shown in operating and sales budgets

(*f*) where applicable, examination of standard costing records and consideration of the variances shown thereby and their treatment in the accounts.

Machine accounting

28 To the extent that tests of the kind indicated in this Statement may be impracticable because of the use of machine accounting under which records are not always available by way of link between primary and ultimate records, the auditors will have regard to the considerations referred to in the Council statement on MECHANISED ACCOUNTING AND THE AUDITOR as amplified by the Council statement on ACCOUNTING BY ELECTRONIC METHODS.

Independent stocktakers

29 The scope of the work undertaken by independent stocktakers and valuers and the details given in inventories submitted by them will need to be considered by the auditors. The fact that the services of such

persons have been used does not eliminate the auditors' duties in relation to the stocks certified by the stocktakers, though it may affect the extent and nature of the tests which the auditors will consider it necessary to apply themselves.

AUDITORS' REPORT

If, as a result of their assessment of the company's procedure and their tests of its operation, the auditors are unable to reach the opinion that the records are reliable they will find it necessary to make an appropriate reservation in their report to the shareholders if the amounts involved are material. 30

Similarly a reservation in their report will be necessary if in the opinion of the auditors the principles adopted by the company and/or the description applied to stock-in-trade and work-in-progress in the balance sheet are not such as to enable the accounts to show a true and fair view. 31

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