

Guidance Note on Audit of Capital and Reserves¹

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¹ Issued in January, 2006. Attention of the readers is invited to the fact that prior to the issuance of this Guidance Note, the aspect of audit of Capital and Reserves was covered by paragraphs 8.1 to 8.18 of the Statement on Auditing Practices. The Statements was withdrawn pursuant to the issuance of the Guidance Note on Audit of Payment of Dividend in August 2005.

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The following is the text of the Guidance Note on Audit of Capital and Reserves, issued by the Council of the Institute of Chartered Accountants of India. The Guidance Note should be read in conjunction with the Standards on Auditing issued by the Institute.

Introduction

1. Capital and reserves constitute the owners' funds. Capital comprises both the amounts contributed by the owners and the profits capitalised over a period of time (by way of issue of bonus shares in case of corporate entities or by way of crediting the retained earnings to the capital account in case of non-corporate entities).
2. Capital may consist of various classes of shares with varying voting rights in case of corporate entities.
3. Reserves are the portion of earnings, receipts or other surplus of an enterprise (whether capital or revenue) appropriated by the management for a general or a specific purpose other than a provision for depreciation or diminution in the value of assets or for a known liability. Reserves comprise both capital and revenue reserves. Ordinarily, revenue reserves are retained earnings, whereas the capital reserves may constitute both retained capital profits and owners' contribution in the form of premium on issue of shares and surpluses resulting from re-issue of forfeited shares. Revaluation reserve arising from revaluation of fixed assets is also a capital reserve.
4. The auditor, in many audit engagements, particularly those relating to corporate entities, may find very few changes in the capital account and/ or reserve accounts. However, the transactions in the capital and reserve accounts are normally material in amount in addition to being significant in nature and, therefore, each transaction in these accounts requires careful attention.
5. In any auditing situation, the auditor employs appropriate procedures to obtain reasonable assurance about various assertions (see Standard on Auditing (SA) 500, *Audit Evidence*). In carrying out the audit of capital and reserves, the auditor is particularly concerned with obtaining sufficient appropriate audit evidence to corroborate the management's assertions regarding the following:

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<i>Existence:</i>	that the recorded amounts of capital and reserves exist at the given date
<i>Occurrence:</i>	that the transactions recorded in the capital and reserve account(s) occurred during the period under audit
<i>Obligation:</i>	that the amounts appearing in the capital and reserves account(s) are in fact a liability of the entity
<i>Completeness:</i>	that there are no unrecorded transactions in respect of capital and reserves account(s)
<i>Measurement :</i>	that the transactions in the capital and reserves account(s) have been recorded at the proper amount
<i>Valuation:</i>	that the amounts recorded in the capital and reserve account(s) are recorded at appropriate carrying value
<i>Presentation and disclosure:</i>	that the items of capital and reserves have been disclosed, classified, and described in the financial statements in accordance with recognised financial reporting framework applicable to the client.

6. The principal objectives of the auditor in the examination of capital and reserves, therefore, are:

- (a) to ascertain that amounts shown in capital and reserve account(s) as at the balance sheet date are correct;
- (b) to determine that all transactions during the year, affecting owners' funds were properly authorised and recorded;
- (c) to examine whether the applicable laws and regulations and terms of issue/ agreement, if any, have been complied with; and
- (d) to verify whether these amounts have been properly classified and disclosed in the financial statements.

Internal Control Evaluation

7. Paragraph 2 of the Standard on Auditing (SA) 400, *Risk Assessments and Internal Control*, requires the auditor to obtain an understanding of the accounting and internal controls relating to capital and reserves sufficient to plan the audit and develop an effective audit approach. Paragraph 1 of the SA 500 requires the auditor to "obtain sufficient appropriate audit evidence through

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the performance of compliance and substantive procedures to enable him to draw reasonable conclusions therefrom on which to base his opinion on the financial information". Paragraph 1 further states:

"Compliance procedures are tests designed to obtain reasonable assurance that those internal controls on which audit reliance is to be placed are in effect.

Substantive procedures are designed to obtain evidence as to the completeness, accuracy and validity of the data produced by the accounting system."

In certain cases, the client may employ a third party to carry out any of its transactions in respect of capital and/ or reserves. For example, it is quite common for listed companies to outsource the administrative aspects related to allotment, issuance of share certificates, share transfer, maintenance of records of shareholders, etc. In such situations, the auditor, as required by Standard on Auditing (SA) 402, "*Audit Considerations Relating to Entities Using Service Organisations*", should also consider how such arrangements affect the client's accounting and internal control system so as to plan and develop an effective audit approach.

8. In the case of non-corporate entities, the auditor needs to ascertain general terms and conditions regarding contribution of capital, interest payable on capital, interest chargeable on withdrawals, limits imposed on withdrawals, etc. In respect of corporate entities, the auditor should particularly review the following aspects of internal controls relating to capital and reserves:

- (a) *Proper authorisation of transactions*: All transactions in the capital and reserves accounts such as issue of fresh shares and allotment, buy back of shares, forfeiture, making calls on the shares, should be properly authorised as required by the Companies Act, 1956. Outsourcing of any services, e.g., depository services should also be with the proper authorisation of a competent authority. The authority to sign the share certificates may be delegated to a person as per the laws applicable to the entity.
- (b) *Proper control over issue and custody of share certificates*: In case where shares are in the physical form, the auditor is required to examine that proper internal control system exists to ensure that the share certificates are pre-numbered, proper accounts are maintained for certificates cancelled due to defacement, wear out, exhaustion of cages to record

transfer particulars, dematerialisation. The auditor should examine whether blank share certificates are under the lock and control of the company secretary or some other responsible officer of the entity. He should also examine whether at least one officer of the entity personally signs the share certificates issued, though other signatures can be facsimile type and whether such a signing officer also verifies the register of share certificates, wherein the issue particulars are recorded. It may be noted that share certificates are generally issued for a fixed lot of shares (marketable lot, or some other predetermined denomination).

- (c) *Allotment and call intimations etc.:* The auditor should examine whether allotment of shares and calls is done pursuant to a resolution of the Board and that proper internal controls exist for dispatch of allotment advices and call letters.
- (d) *Internal control on receipts and accounting of application, allotment and call money:* Internal controls applicable for receipt and accounting of money received on application, allotment and calls need to be evaluated. Proper records should be maintained for recording the said transactions. Periodical reconciliation of bank accounts opened specially for transactions in capital account have to be made.
- (e) *Maintenance of adequate records:* The auditor should verify whether proper system of internal controls for documentation is in operation. It includes maintenance of proper and adequately detailed records in respect of the details of members, share certificate stock ledger, duplicate certificates, cancelled certificates, etc.
- (f) *Proper control over issue of instructions to depository participants:* There should exist proper controls over issue of instructions to and for execution of requests received from the depository participants for the dematerialisation/re-materialisation of shares and proper records are required to be maintained for recording such transactions.

Internal Controls relating to Outsourced Activities

9. For the efficient carrying out of the day to day transactions like issue of share certificates/instructions to depository participants for the credit of shares on allotment, either on public issue or rights issue, issue of call letters, etc., authority may be delegated, at the general meeting, to registrars and share transfer agents. In such cases, the auditor should follow the procedures described by the SA 402.

Verification

10. Verification of capital and reserves may be carried out by employing the following procedures:

- (i) examination of records;
- (ii) examination of compliance with laws and regulations and terms of issue/ contract, if any; and
- (iii) examination of presentation and disclosure.

11. The nature, timing and extent of substantive procedures to be performed is, however, a matter of professional judgment of the auditor which is based, *inter alia*, on the auditor's evaluation of the effectiveness of the related internal controls.

Entities Other Than Partnerships and Sole Proprietorships

Examination of Records

Capital

Authorised Capital

12. The authorised capital shown in the balance sheet should be checked with the Memorandum of Association in case of a company, registered byelaws in case of a co-operative society, relevant statute or the Government Order in case of a statutory corporation or other body corporate. The auditor may also refer the audited balance sheet of the immediately preceding year.

13. The minutes of the general meeting and/ or Board should be examined to see, if any, change in the capital structure has taken place since the last balance sheet and whether it is properly authorised. A company, having a share capital, in terms of the provisions of section 94 of the Companies Act, 1956 may change its share capital as follows:

- (i) increase its share capital by such amount as it thinks expedient by issuing new shares
- (ii) consolidate or divide all or any of its share capital into shares of larger amount than its existing shares
- (iii) convert all or any of its fully paid up shares into stock, and reconvert that stock into fully paid-up shares of any denomination

- (iv) sub-divide its shares, or any of them, into shares of smaller amount than is fixed by the memorandum
- (v) cancel shares which, at the date of passing of the resolution in that regard, have not been taken or agreed to be taken by any person, and diminish the amount of its share capital by the amount of the shares so cancelled

In such cases, the auditor should also examine the copy of the documents filed with the Registrar of Companies in relevant form along with the specified fee pursuant to the requirements of section 97 of the Companies Act, 1956. In addition to the situations envisaged in section 94 of the Companies Act, 1956, the auditor should also enquire whether the Central Government has, under Section 81(4) ordered or directed under Section 94A(2) of the Companies Act, 1956, the conversion of debentures or loans into share capital, resulting in an increase in the authorised capital of the company. The authorised capital may also undergo a change, as a consequence of a merger or a demerger. Similarly, in case of statutory corporations, amendments made to the statute governing the entity or the Government Order in case of other public sector bodies should be enquired into.

Issued and Subscribed Capital

14. *Issued Capital:* The following records/documents would ordinarily provide necessary evidence for issued capital:

- (a) The minutes of the general and/ or board meetings for further issue of shares, e.g., under section 81 of the Companies Act, 1956;
- (b) Offer documents, if any, filed with the Securities and Exchange Board of India (SEBI)/Registrar of Companies (ROCs) and Reserve Bank of India (RBI) in respect of permission in case of ADR/GDR issue.
- (c) Return of allotment filed with the Registrar of Companies.

15. *Subscribed Capital:* Shares subscribed in response to the issue of capital can be verified by reviewing the applications received for the subscription of shares. The subscribed capital is the capital for which the application money is received. The subscribed share capital cannot exceed the issued capital.

Paid up capital

16. Periodical reconciliation of outstanding shares held in demat and physical form as on book closure/ record date should also be done.

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17. The auditor should review the minutes books of Board of Directors and the members and also any amendments made to the statutory register to ascertain whether any changes have taken place in the capital of the entity, for example –

- A. Increase in capital due to:
 - (i) Fresh issue of shares/ADR/GDR.
 - (ii) Allotment of shares pursuant to merger/amalgamation or acquisition of property or services.
 - (iii) Part/full conversion of loans or debentures
 - (iv) Allotment of shares pursuant to exercise of option either by the promoters or the employees or other option holders.
 - (v) Allotment of Bonus shares
 - (vi) Rights issue
- B. Decrease in capital due to:
 - (i) Forfeiture
 - (ii) Buy-back of shares
 - (iii) Redemption of redeemable preference shares
 - (iv) Reduction of capital
 - (v) Surrender of shares as in the case of Co-operative societies
 - (vi) De-merger

18. A list of members, together with shares held by them and the amounts paid-up thereon, should be available with the company/entity as at the balance sheet date and the aggregate of these should agree, with the details of capital shown in the balance sheet. A copy of the annual return for the previous year filed under the Companies Act, 1956 or any other statute or a list of members prepared for issuing dividend warrants may also be examined. If the auditor chooses to verify the list of members as per the annual return or list of members prepared for issuing dividend warrants, he should also check the reconciliation with the amount as at the balance sheet date, with the changes occurred during the period from the date of balance sheet and record date/ book closure date. Where the registration work is carried out by independent specialised agencies, a certificate, containing the list of members, the number

of shares held, including those in the demat form and physical form and amount paid up on these shares and calls in arrears, if any, should be obtained and reconciliation of the particulars with the amount credited as paid up in the share capital account of the General Ledger be checked on a test basis.

19. If a change in the capital has taken place during the year under audit, inquiries should be made to ascertain that it is properly authorised in the manner prescribed by the Articles and appropriate resolutions have been passed with requisite majority.

20. The auditor should enquire whether the Central Government has passed any order under Section 108 or Section 250 of the Companies Act, 1956 freezing the voting rights of any shareholders. It may be noted that there are provisions in the Banking Regulation Act, 1949 limiting the voting rights of a person. Similarly, the Co-operative Societies Act, 1912 provides for issue of two types of shares, one having voting rights and other not having voting rights. The Companies Act, 1956 also provides for issue of shares with non voting rights. These matters have a bearing while examining the validity of the resolutions passed by the members of the entity. The auditor should, therefore, also check that the classes of shares have been appropriately disclosed.

Subscription in Cash and Kind

21. The law requires a distinction to be made between shares subscribed for in cash and shares subscribed for consideration other than in cash. Shares subscribed for in cash should include only the following kinds of subscription: -

- (a) where the subscription amount is received either in cash or by cheque;
- (b) where the amount is adjusted against a *bona fide* debt payable in money at once by the company.

There might be situations where a company has taken a loan under a stipulation that in case of default in repayment of the loan, the loan would get converted into shares. In such a situation, on a default in repayment of the loan by the company, if the loan gets converted into shares in the company, such shares would be considered as having been allotted for cash. Where shares are allotted against credit balance in a person's account, inquiry should be made as to how the credit balance in that account has arisen, whether it was for a valid consideration and whether the amount was due for payment at the time of issue.

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22. The Department of Company Affairs² has clarified through its circular No. 8/32(75) 77-CL-V dated 13th March, 1978, that a genuine debt adjusted against the amount receivable towards share capital can be treated as amount paid in cash. The extracts from the advice received from an eminent Counsel in this regard are given as **Appendix A** to this Guidance Note.

23. Where the subscription for share capital is paid into a bank account in a foreign country, it should be verified that the amount deposited in the foreign currency is in accordance with the terms of issue and such an amount as, if remitted into India on the day on which the deposit is made in the foreign country, would have realised in Indian rupees a sum equal to the amount credited as paid up and premium, if any, on the shares. The auditor should verify that the guidelines issued by SEBI for inviting, collecting and recording of foreign capital have been complied with by the company. The foreign exchange fluctuations, if any, should be accounted for in the balance with bank in accordance with the provisions of Accounting Standard 11, *The Effects of Changes in Foreign Exchange Rates*.

24. *Issue of Shares for Consideration Other than Cash:* Shares may also be issued for a consideration other than cash, e.g., for supply of machinery or technical know-how. The auditor should examine the underlying agreement in respect of the same and verify whether the agreement has been properly approved. The auditor should treat the shares issued for consideration other than cash separate from those issued against cash in his audit approach. He needs to verify that the consideration for which shares are issued, viz., supply of machinery or technical know-how is *prima facie* fully received.

25. Further, as per the provisions of section 75 of the Companies Act, 1956, whenever company having a share capital makes any allotment of its shares, the company has to comply with the following conditions:

- i. It has to file with the Registrar of Companies, a return of the allotment, stating the number and nominal amount of shares comprised in the allotment, the names, addresses and occupations of the allottees, and the amount if any, paid or due and payable on the shares.
- ii. In case of shares allotted for other than cash, it has to produce before the Registrar, *inter alia*, a contract in writing, constituting the title of the allottee to the allotment together with any contract of sale, or a contract

² Now known as the Ministry of Company Affairs.

for services or other consideration in respect of which allotment was made.

26. The auditor may examine the following records to the extent they are applicable to the particular circumstances, in case of increase in paid-up capital:

- (a) Final price determined in case of offer through book building process³.
- (b) Scheme of compromise or arrangement as referred to in section 394 of the Companies Act, 1956, approved by the Court.
- (c) Compromise proposal with creditors and the consequential Order of the Court or an Order of Central Government under Section 397 of the Companies Act, 1956.
- (d) Procedure and terms of reissue of forfeited shares.

27. In case the payment is allowed to be made on allotment and/ or also in installments of one or more calls, the auditor has to verify the resolution of the Board for making calls, amount received against the calls and the posting of the amount to the correct member's account/folio. A schedule of allotment money and a schedule for each call have to be verified on test check basis and reconciled with total amount received and due on allotment and each call. If the accounting work relating to the share capital is outsourced to a Registrar and Share Transfer Agent, the auditor should follow the principles enunciated in SA 402. If the Articles of Association permit and the terms of issue state that in the event of delay in payment of either allotment money or calls, the investor has to pay interest, the auditor should verify whether such interest is collected and properly accounted for in the books of account. The auditor should review the schedules of calls in arrears and calls in advance, and ensure that interest is provided in accordance with the Articles of Association, Offer Documents/Terms of Issue. The auditor may verify the Board Resolution, if any, for waiver of interest on calls in arrears. Interest on calls in arrears may

³ *Book Building Process*: Listed companies can also issue shares through Book Building Process. Book Building is a process wherein the issuer of securities asks investors to bid for his securities at different prices. These bids are within an indicative price-band, decided by the issuer. Here, investors bid for different quantity of shares, at different prices. Considering these bids, the issuer determines a cutoff price, which is the price at which the securities are allotted. SEBI has issued guidelines on issue of shares through Book Building Process. The auditor has to verify whether the company has complied with all the guidelines issued by SEBI in this regard and also that the basis of determination of the floor price and the final price by the company is consistent with the provisions in that regard.

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be accounted at the time of receipt, with proper disclosure in the balance sheet for deviating from the accrual principle. The schedule of calls in arrears should show separately the amounts, if any, due from the directors. Similarly, the auditor should also examine the payment of interest on calls received in advance, if any, made by the company. He should verify whether any such payment of interest on calls received in advance is permitted by the articles of association of the company. He should also examine the Board resolution in this regard.

28. In case shares are issued at discount, the auditor has to verify the compliance of Section 79 of the Companies Act, 1956.

29. Generally, employees are offered shares at a price lesser than the market rate. Sections 79 and 79A of the Companies Act, 1956 and SEBI (Employee Stock Option Scheme and Employees Stock Purchase Scheme) Guidelines, 1999 (ESOS and ESPS), Employee Stock Option Scheme for Public Sector Enterprises and others statues governing the entity have to be complied with. Transactions relating to options are to be accounted as required by the said scheme or the Accounting Standards and provisions of any relevant statute, if any, in force, on treatment of discount etc., on ESOS/ESPS.

30. *Issue of Sweat Equity*: Section 79A of the Companies Act, 1956 deals with the issue of sweat equity by the company to its employees and directors, at a discount or for consideration other than cash for providing know-how or making available rights in the nature of intellectual property rights or value additions, by whatever name called. SEBI has also issued SEBI (Issue of Sweat Equity) Regulations, 2002 for issue of the sweat equity by the listed companies. The issue of sweat equity by unlisted companies is governed by Unlisted Companies (Issue of Sweat Equity Shares) Rules, 2003⁴. The auditor must verify that if the company has issued any sweat equity, whether the provisions of Section 79A of the Companies Act, 1956 and the Rules applicable to the company, depending whether listed or not, have been complied with.

31. Companies are now allowed to buy-back their own shares. Sections 77A and 77B of the Companies Act, 1956 lay down the conditions and procedures for buy-back of the shares of a company. In case of private limited and unlisted companies, the Private Limited Company and Unlisted Public Limited

⁴ Issued by the Ministry of Company Affairs vide Notification number GSR 923E dated 4th December, 2003.

Company (Buy-back of Securities) Rules 1999, and in case of listed companies, SEBI (Buy-back of Securities) Regulations, 1998 have to be complied with. The auditor should verify particularly that the funds employed for the buy-back are from the resources as permitted by the law. The reconciliation of entries in escrow account or the bank account separately opened for payment of purchase consideration have to be verified with the number of shares bought back and price paid. The auditor should also verify the entries made in the concerned books/registers with regard to destruction of share certificates and extinguishments of dematerialised shares and a reconciliation of these two to arrive at the total number of securities purchased under buy-back process.

32. Registered Byelaws of the Co-operative Societies specify the terms and conditions for surrender of all or certain class of shares. Generally, surrender of shares is allowed only at par. The auditor has to verify the certificates surrendered vis-à-vis the payment made and the entries made in the Register of members, share certificate ledger etc.

33. In case of reduction of capital is by way of reduction of the nominal value of the shares, either by canceling unpaid portion of the partly paid shares, or extinguishing some part of the paid up capital, the auditor has to verify that the High Court Order under Section 100 of the Companies Act, 1956 for reduction of capital has been complied with. Further, he has to verify the share certificates surrendered and the statement of corresponding new share certificates issued. In case reduction is achieved by canceling fully paid shares proportionately, the auditor should also verify the surrendered shares/issue of stickers/intimation to the depositories vis-à-vis the amount reduced.

34. It may be noted that the buy-back of shares under Section 77A and redemption of redeemable preference shares under Section 80 do not attract the provisions of Section 100 of the Companies Act, 1956.

Application Money

35. Schedule VI to the Companies Act, 1956 does not prescribe the manner of disclosure of share application money. However, as a matter of prudence and better disclosure, share application money should be shown separately between "Share Capital" and "Reserves & Surpluses" in the Balance Sheet till the time share application money is transferred to the Share Capital Account. However, in the following situations, the share application money would be disclosed separately under the head "Current Liabilities" in the Balance Sheet:

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- invalid or revoked applications;
- excess application money received due to over subscription; and
- when minimum subscription stated in the offer document is not received.

36. The auditor has to verify whether application money stated is fully backed by the share application forms/certificate from the Share Transfer Agent and applications are received pursuant to a resolution of the appropriate authority for issue of capital. Amount received without satisfying any of the above conditions should be refunded by the company.

37. Share application money accepted by the company, if not backed by the application form/Registrar's certificate alongwith the resolution of the Board as stated above, should be treated as unsecured loan. The auditor should verify that the application money received in excess of capital offered for subscription, if any, has been stated under Current Liabilities. The auditor may examine the reasonableness of the period for which the share application money remains pending allotment.

38. In case of refund of excess application money/revoked applications, the auditor should verify the same and apply the similar audit procedures as applied for audit of any other liability. The auditor should also verify whether the company has complied with the Guidelines prescribed by SEBI with regard to time schedule and payment of interest in case of delay in such refunds.

Calls Received in Advance

39. The auditor should examine whether the calls received in advance and payment of interest, if any, thereon is in accordance with the provisions contained in the Articles of Association in this regard. Schedule of calls received in advance is to be reviewed with reference to the amounts deposited in the bank.

40. Interest, if any, paid on the amount received in advance of calls should be verified and the audit procedure to be employed is same as in case of payment of interest on borrowings.

General

41. The auditor should examine whether proper accounts have been maintained with regard to amounts received on application, allotment and calls and the payments by way of refunds/interest and all other relevant accounts are duly reconciled. Where shares are issued at a premium, the auditor should

ensure that such sums are accounted for separately. In case of buy back, reissue or redemption of preference shares and reduction of capital by payment of money, the auditor should examine whether these have been properly accounted and duly reconciled with payments made for the same.

42. Proviso to section 383A of the Companies Act, 1956 requires certain companies to obtain a certificate of compliance with the provisions of the Companies Act, 1956 from a practicing company secretary. The auditor of such companies may review the same.

Reserves

43. Reserves should be distinguished from provisions. For this purpose, reference may be made to the definitions of the expressions, "provision" and "reserve", etc., in the Guidance Note on Terms Used in Financial Statements issued by the Institute. The definition of the term "reserve" as given in the said Guidance Note is explained in paragraph 3. It is important to remember that any amount provided in excess of the requirements is in the nature of reserve and should be shown as such.

44. It is also necessary to make a distinction between capital reserves and revenue reserves in the accounts. A Revenue Reserve is ordinarily available for distribution as dividend.

45. Reserves may also contain amount received from the Government. These grants may be in the nature of promoters' contribution or related to any specific fixed asset. The auditor should verify that the principles of Accounting Standard 12, '*Accounting for Government Grants*' for recognition, presentation, refund, if required, and disclosure of the grant have been appropriately complied with.

46. A reserve account is styled as Reserve Fund only when such reserves are represented by specifically earmarked assets or investments.

47. In case of amalgamations and mergers, reserves of the amalgamated /merged company have to be treated as prescribed in Accounting Standard 14, '*Accounting for Amalgamations*' issued by the Institute. However, the auditor, especially in cases of amalgamations/ mergers, may come across a situation where the relevant Court/ Tribunal has made an order sanctioning an accounting treatment different from that prescribed by an Accounting Standard. In such a situation, the attention of the members is drawn to the announcement of the Council of the Institute in this respect. The Council has recommended

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that the following disclosures be made in the financial statements for the year in which different treatment has been given:

- (i) A description of the accounting treatment made alongwith the reason that the same has been adopted because of the Court/ Tribunal order.
- (ii) Description of the difference between the accounting treatment prescribed in the Accounting Standard and that followed by the Company.
- (iii) The final impact, if any, arising due to such a difference.

Capital Reserves

Capital Redemption Reserve

48. In terms of the provisions of sections 77A and 80 of the Companies Act, 1956, if the company redeems the preferential share capital or buys back its own shares, using the retained earnings, the amount equivalent to the nominal value of the shares redeemed/bought back have to be transferred to the capital redemption reserve, and such reserve can be utilised only for issue of bonus shares to the members of the company.

Securities Premium Account

49. Any premium realised on issue of securities should be transferred to Securities Premium Account and utilised only for the purposes laid down in section 78 of the Companies Act, 1956.

Government Grants

50. Grants, contributions and subsidies received from Government specifically for acquisition of assets have to be treated and disclosed in the financial statements as laid down in Accounting Standard 12, issued by the Institute.

Revaluation Reserve

51. Reserves arising out of revaluation of fixed assets are to be transferred to the Revaluation Reserve account. The treatment and utilisation of these reserves is governed by the "Guidance Note on Treatment of Reserve Created on Revaluation of Fixed Assets" and "Guidance Note on Availability of Revaluation Reserve for Issue of Bonus Shares" issued by the Institute.

Statutory Reserves

52. Section 17 of the Banking Regulation Act, 1949 and certain provisions in

the Co-operative Societies Act, 1912 provide for creation and utilisation of certain specific reserves. Laws governing other entities may contain similar provisions as to the creation and utilisation of such reserves. The regulators may also direct the entities to create some specific reserves, for example, the Reserve Bank of India has directed all banking companies to create and transfer certain amount of profits earned on trading of investments to Investment Fluctuation Reserve and has also stipulated the purpose for which such reserve can be utilised. The auditor should familiarise himself with such regulatory directions with respect to creation and utilization of such specific reserve and verify compliance therewith.

Revenue Reserves

53. A revenue reserve is a reserve, which is available for distribution as dividend. The auditor should examine the legal provisions governing the entity with regard to transfer of certain percentage of profits to reserves, for example, the requirements of section 205 (2A) of the Companies Act, 1956, the Reserve Bank of India Directions in case of Non Banking Financial Companies, etc.

54. Certain other statutes may require transfer of profits to reserves. For example, the Income-tax Act, 1961 may require creation of certain reserves and provide for rules for utilisation of such reserves to claim certain fiscal benefits. The auditor should examine the need for transfer of profits to reserves and utilisation of such transfers.

Examination of Compliance with Laws and Regulations

55. Standard on Auditing (SA) 250, *Consideration of Laws and Regulations in an Audit of Financial Statements* requires that "when planning and performing audit procedures and in evaluating and reporting the results thereof, the auditor should recognise that non compliance by the entity with laws and regulations may materially affect the financial statements." The auditor should therefore acquire sufficient knowledge of the legal and regulatory framework within which the client operates. This assumes added importance in cases of audit of capital and reserves of companies since the matters relating to the share capital and reserves are governed by the provisions of the Companies Act, 1956, especially the provisions contained in sections 69 to 116, section 177C, section 205(2A) of the said Act. For example, sections 69 to 116 of the Companies Act, 1956 regulate the matters relating to issue and allotment of shares, section 205 (2A) and section 177C of the Companies Act, 1956 contain provisions relating to creation and utilisation of certain reserves and section

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187C deals with the situation where the beneficial owner of the shares of the company is different from the person whose name is appearing in the shareholders' register of the company. Guidelines issued by the Securities and Exchange Board of India from time to time also contain the matters relating to the issue and allotment of shares in case of public offer and substantial acquisition of shares in case of existing listed companies. Moreover, the Articles of Association of the entity may also have provisions relating to share capital and reserves. The Companies Act, 1956 requires compliance with the Articles of Association in so far as they are not contradictory to the provisions of the Act. Hence, it is very important to verify the compliance with the laws and regulations governing the entity.

56. The State Co-operative Societies Acts may have conditions as to minimum paid up capital and also minimum number of members for co-operative societies and with regard to creation and utilisation of various reserves. Statutes governing the entity may contain similar provisions with regard to the number of members and minimum amount of capital. The auditor should be familiar with the laws governing the entity. The auditor has to carefully examine the compliance of such legal requirements.

57. The auditor has to examine the compliance with the various rules and regulations, for example:

- (a) Government Order, if any, the Memorandum and the Articles of Association of the company or the Rules and Regulations governing the entity.
- (b) Terms of issue attached or subsequently approved in case of conversion of loans or convertible preference shares.
- (c) Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism) Scheme, 1993 and Guidelines on Euro Issues.
- (d) Rules and Regulations relating to issue and buy back of ADR/GDR.
- (e) Chapter XIII of SEBI (Disclosure and Investor Protection) Guidelines 2000 in case of preferential issue.
- (f) Unlisted Public Companies (Preferential Allotment) Rules, 2003.
- (g) Unlisted Companies (Issue of Sweat Equity Shares) Rules, 2003.
- (h) Any other Rules and Regulations prescribed by Government/ SEBI from time to time.

Examination of Presentation and Disclosure

58. The laws governing the entity may prescribe the format for disclosure of information relating to the Capital and Reserves in its Balance Sheet. For example, the Companies Act, 1956, the Banking Regulation Act, 1949, the Electricity Act, 2003 and Insurance laws prescribe the format of Balance Sheet and the manner of disclosure of the capital and reserves in the financial statements. The auditor should examine compliance with such disclosure requirements and adequacy thereof. Where the relevant statute lays down any disclosure requirements in this behalf, the auditor should examine whether the same are complied with, for example, SEBI requires that in case of public issue and preferential issue of shares and/or partly/fully convertible debentures, purpose for which these monies are utilised and the manner in which the unutilised money is invested should be disclosed. Sometimes, it may be necessary to disclose the information either in the Significant Accounting Policies and Notes on Accounts to clarify the matters, for example, any employee options outstanding, etc. The auditor should examine such necessity and consider whether appropriate disclosures such as those listed below have been made:

- Aggregate number and class of shares allotted as fully paid up pursuant to contract(s) with or without payment being received in cash
- Aggregate number and class of shares allotted as fully paid by way of bonus shares
- Aggregate number and class of shares bought back
- Source of issuance of bonus shares during the year, if any
- Preference Share Capital, including terms of redemption or conversion
- Shares with differential rights

Special Considerations Applicable to Partnership Entities

59. The most significant document underlying the partnership form of organisation is the Partnership Deed.

60. The Partnership Deed generally provides the capital required to be contributed by the partners and their respective share in profits and losses and interest, if any, on the capital contributed or balances to their credit. The Partnership Deed may also provide for the treatment of excess capital contributed by any partner and their respective rights relating to the withdrawals from capital/drawing accounts.

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61. It may be possible that one or more partners contributes the capital in kind rather than in cash. For example, the premises required for the business may be provided by a partner as his capital contribution. If such contributions are in kind at the time of admission of the partners, the value of such assets is generally mentioned in the Partnership Deed. If the value is not mentioned in the Partnership Deed, the auditor may request for a declaration of the value in writing by all the partners. He should also obtain necessary audit evidence for supporting the valuation.

62. The partnership deed may also provide for fixed capital contribution and timing of contribution by each partner. The auditor should examine whether the capital contributed by each of the partners is in accordance with the Partnership Deed and the capital is maintained at the level mentioned in the Partnership Deed throughout the period of audit.

63. If the Partnership Deed places any restrictions on the drawings of the partners, the auditor should examine whether the drawings have been within the permissible limit.

64. The auditor has to verify the correctness of the interest, if any, credited or debited to the partners' capital or drawings account.

65. Generally, remuneration, interest on capital, interest on drawings, profits or losses are adjusted in the capital accounts or the drawing accounts of the partners, and Reserve accounts are not maintained in case of partnership accounts. However, if fiscal or any other law require any reserve has to be created for claiming any benefit, a reserve with appropriate title may be created out of the profits of the firm. The rules for utilisation of the reserve may be provided in the relevant laws. In such event, the auditor should examine the compliance with the same. Sometimes, the partners may decide to create and utilise certain reserves due the exigencies of the business, in which case the auditor has to verify the compliance of the decision of the partners. In case the entity has not complied with the prescribed reserve utilization requirements, he should consider the effect of the same on his audit report in terms of the principles laid down in the SA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*.

66. Special Reserves, created to meet the requirements of any law, may be credited to the Partners' Capital Accounts on fulfillment of such statutory requirements or the terms of creation of such reserves.

67. Government grants and subsidies received shall have to be accounted for in accordance with Accounting Standard 12.

68. Where either investments or drawings have come from Non Resident Indians or foreign sources involving foreign currency, the auditor has to verify the compliance of RBI regulations as well as the provisions of the Foreign Exchange Management Act, 1999 in this regard.

69. All transactions in the partners' capital account and drawings account have to be vouched for their correctness.

70. The auditor has to verify that the distribution of profit/loss is as per the terms of Partnership Deed. It may be noted that if any minor is admitted to the benefits of partnership, no loss should be apportioned to the share of minor.

71. If a partner dies/retires during the year, the partnership entity may prepare accounts up to the date of such death/retirement to ascertain the claim of heirs/retiring partner. In such event, the auditor has to verify the apportionment of the profit/loss for both the periods.

Special Considerations Applicable to a Sole Proprietary Entity

72. The audit of capital account of the sole proprietor poses considerable problems, as the capital account is generally maintained as a current account. Generally, the entries in the capital account are many, when compared with other forms of entities. The capital introduced by the proprietor in the entity may be in cash or in kind. The introduction of capital can take place at number of times, depending upon the need for the working capital in the entity. Similarly, the drawings are made for various personal expenses.

73. It may also be possible that the personal expenses of the proprietor are booked in the accounts of the business without appropriately reflecting them in those accounts.

74. Generally, internal control procedures are inadequate or absent in many sole proprietary entities. Hence, the auditor should be careful while examining the accounts of such entity. Though the auditor needs to obtain the same level of assurance in order to express an unqualified opinion on the financial statements of both small and large entities, however, many internal controls which would be relevant to large entities are not practical in the small business. For example, in small businesses, accounting procedures may be performed by a few persons who may have both operating and custodial responsibilities, and therefore segregation of duties may be missing or severely limited. Inadequate segregation of duties may, in some cases, be offset by a strong

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management control system in which owner/manager supervisory controls exist because of direct personal knowledge of the entity and involvement in transactions. In circumstances where segregation of duties is limited and audit evidence of supervisory controls is lacking, the audit evidence necessary to support the auditor's opinion on the financial statements may have to be obtained entirely through the performance of substantive procedures. He should apply his professional judgment based on the knowledge of the business he has acquired to determine whether the expenditure recorded is in fact relevant and appropriate to the business and also all expenditures are recorded in the books of account.

75. The auditor should examine the nature of assets included in the balance sheet of the entity and verify whether such assets are relevant and appropriate to the nature of the business and recorded at fair value.

76. Generally profits or losses are adjusted in the capital account or the drawings account of the proprietor, and reserve accounts are not maintained in case of sole proprietorship accounts. However, if fiscal laws require any reserve to be created for claiming any fiscal benefit, a reserve account with appropriate title may be created out of the profits of the firm. The rules for utilisation of the reserve account may be provided in the same fiscal laws. In such event the auditor should examine the compliance with such laws.

77. Special Reserves created, if any, pursuant to fiscal laws, upon fulfillment of the terms of such reserves, have to be transferred to the capital account of the sole proprietor.

78. Government grants and subsidies received shall have to be accounted for in accordance with Accounting Standard 12.

Management Representations

79. The auditor should obtain from the management of the entity, a written representation on significant aspects of capital and reserves accounts, viz., that all the transactions in the capital and reserves have been recorded and recorded at correct values; that there are no unrecorded transactions in the capital and reserves accounts, that the year end balances (including any notes to the accounts in respect thereof) of the capital and reserves accounts have been appropriately presented and disclosed in accordance with applicable financial reporting framework, in the financial statements, that the management has complied with all the applicable rules and regulations while undertaking transactions relating to capital and reserves.

Documentation

80. The auditor should maintain adequate working papers documenting significant aspects of audit such as:

- (a) the nature, timing, extent and results of the audit procedures performed to comply with Standards on Auditing and applicable legal and regulatory requirements;
- (b) the audit evidence obtained;
- (c) the conclusions reached on significant matters ; and
- (d) in relation to audit procedures designed to address identified risks of material misstatement, conclusions that are not otherwise readily determinable from the procedures performed or audit evidence obtained.

However, it may be noted that the extent of documentation is a matter of professional judgment since it is neither necessary nor practical that every observation, consideration or conclusion is documented by the auditor in his working papers.

APPENDIX A

**EXTRACTS FROM COUNSEL'S OPINION REFERRED TO
IN PARA 22 –“SUBSCRIPTION IN CASH AND KIND”**

“The ratio of Spargo's case is that if there is on the one side a bona-fide debt payable in money at once by the company (hereinafter called “debt”), and on the other side a bona-fide liability to pay money on allotment of shares, so that if bank notes are handed from one side of the table to other in payment of calls, they may legitimately be handed back in payment of the debt. The law does not make it necessary that the formality should be gone through of the money being handed over be taken back again, and if the two demands are set off against each other the shares have been paid for in cash. This is still good law and on facts similar to those of Spargo's case it would be right for a company to show in its accounts the shares as having been allotted for cash.

It is the necessary implication of Section 227(1A)(f) that shares may be correctly stated to have been allotted for cash even though cash may not have been actually received in respect of such allotment If the Auditors find that the case is covered by the ratio of the decision in Spargo's case, no comment would be required from the Auditors and the statement in the Balance Sheet and other accounts that the shares were allotted for cash must be accepted as correct, regular and not misleading, although no cash had been actually received by the company.....

The function of Section 75(1) is merely to impose an obligation on the company to file a Return of the Allotments with the Registrar. Now, the expression “share allotted for cash” is an ambiguous expression. It may mean shares allotted for cash actually received by the Company, or it may mean shares allotted for cash not actually received but adjusted against a debt. In order that this ambiguity may be removed and the Registrar may know the precise factual position, Section 75(1)(a) requires that in the Return of Allotments to be filed with the Registrar shares should not be shown as having been allotted for cash if cash has not been actually received. This, however, does not prevent the company from stating in the Return that shares not shown in the Return as having been allotted for cash were in fact allowed against adjustment of a debt, and consequently such shares would be shown in the company's accounts as having been allotted for cash.”