CHAPTER - 5

STATUTORY REQUIREMENTS OF FINANCIAL STATEMENTS & AUDIT OF DIVIDENDS

MAINTENANCE OF BOOKS OF ACCOUNT

- Sec. 209(1) of Companies Act, 1956 requires every company to keep at its *registered office or at such other place in India* as the Board of directors may decide, proper books of accounts with respect to:
  (a) all sums of money received and spent and the details thereof;
  (b) all sales and purchases of goods;
  (c) the assets and liabilities; and
  (d) such particulars relating to utilisation of material or labour or items of cost as may be prescribed by the Central Govt. in the case of a company engaged in production, processing, manufacturing or mining activities.
- If the directors decide to keep the books or any of the books at a place other than registered office, the Registrar must be notified within seven days of the decision.
- Sec. 209(2) provides that where a company has a branch office, whether in or outside India, books of account relating to the transactions at the branch may be kept at the branch, but proper summarized returns must be sent by the branch to the company at its registered office at intervals of not more than three months.
- Sec. 209(3) requires that the books of account should be maintained on *accrual basis* and according to the *double entry system* of accounting to ensure that these represent *true and fair view* of the affairs of the company or branch office and all transactions are fully explained.
- Sec. 209(4) provides that the books of account and other books and papers shall be open to inspection by ant director during business hours.
- Sec. 209(4A) requires that the books of account and the relevant vouchers must be preserved for a minimum of eight years in good order.

PERSONS RESPONSIBLE FOR KEEPING THE BOOKS OF ACCOUNT: [Sec. 209(6)]

- Managing Director or Manager;
- Where the company has neither a M.D. nor manager then every director of the company.

If any of the persons referred above fails to take all reasonable steps to secure compliance by the company with the requirements for keeping books of account or has by his willful act been the cause of any default by the company in this respect, he is punishable with imprisonment upto six months or with fine which may extend to Rs. 10,000 or with both. No person shall be sentenced to imprisonment unless it is proved that he contravention was committed by him willfully.

PREPARATION AND PRESENTATION OF FINAL ACCOUNTS: [SEC. 210]

As per Sec. 210 of the Companies Act, 1956 at every AGM of the company the Board of directors of the company shall lay before the company:

- A Balance Sheet as at the end of the accounting period which has just ended, and
- A Profit and Loss Account for that period.

In case of a company not carrying on business for profit, an Income and Expenditure account shall be laid before the company at its AGM instead of Profit and Loss a/c.

FORM AND CONTENTS OF BALANCE SHEET AND P & L A/C: [SEC. 211]

Every balance sheet of a company should give a *true and fair view* of the *state of affairs* of the company and should be in the form set out in Part I of Schedule VI.

The profit and loss account should give a *true and fair view* of the *profit or loss* of the company and should comply with requirements of Part II of Schedule VI.

SCHEDULE VI OF THE COMPANIES ACT:

Part I	– Two alternative forms of balance sheet, horizontal and vertical
Part II	– Requirements as to P & L a/c. No performa has been prescribed
Part III	– Interpretation of certain terms
Part IV	– Balance sheet abstract and general business profile

TRUE AND FAIR VIEW

- The concept of "true and fair" is a fundamental concept in auditing. The phrase "true and fair" in the auditor's report signifies that the auditor is required to express his opinion as to whether the state of affairs and the results of the entity as ascertained by him in the course of his audit are truly and fairly represented in the accounts under audit. This requires that the auditor should examine the accounts with a view to verifying that all assets and liabilities, incomes and expenses are stated at the amounts which are in accordance with accounting principles and policies, and no material item has been omitted.

- What constitutes "true and fair" has not been defined in the legislation. However, section 211 (1) and (2) of the Companies Act, 1956 states that every balance sheet of a company shall give a true and fair view of the state of affairs of the company at the end of the financial year and every 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.
- However, section 211 (5) of the Companies Act, 1956 states that the balance sheet and profit and loss account of a company shall not be treated as not disclosing a true and fair view of the state of affairs of the company if they do not disclose any matters which are not required to be disclosed by virtue of the provisions of Schedule VI to the Companies Act, 1956, or by virtue of any notification or any order.
- Therefore the auditor must see that the accounts are drawn up as per requirements of the provisions of Schedule VI, and whether they contain all matters required to be disclosed therein. In case of companies governed by special Acts, say, banking, electricity, etc. the auditor should see, whether the relevant disclosure requirements are complied with. Thus, what constitutes a true and fair view is a matter of the auditor judgement in the particular circumstances of the case.
- In specific terms to ensure truth and fairness, an auditor has to see:
  (i) that the assets are neither undervalued or overvalued;
  (ii) no material asset is omitted;
  (iii) the charge on assets, if any, is disclosed;
  (iv) material liabilities should not be omitted, and liabilities are neither undervalued or overvalued;
  (v) accounting policies have been followed consistently;
  (vi) all unusual, exceptional, non recurring items have been disclosed separately;
  (vii) accounts have been drawn as per requirement of Schedule VI to the Companies Act; and
  (viii) the accounts have been drawn in compliance to the relevant accounting standards. In case of deviation from accounting standards, disclosure should be made of the reasons for such deviation and financial effects, if any arising due to such deviation.

Previous Years Questions

Q. No. 1: What is your understanding of the term "True and Fair View" in a statutory audit report of a company. *[May 03 (8 Marks)]*

Q. No. 2: When can a company be said to have 'Not Maintained 'proper books of accounts? What is the role of the statutory auditor for the same. *[May 05 (6 Marks)]*

Payments controlled by the Companies Act, 1956

(a) Sec. 227 (1A) (e) requires personal expenses charged to the revenue account of a company should be reported.

(b) Under section 293, 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 such public company or subsidiary in general meeting.
  (i) 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;
  (i) remit, or give time for the re-payment of, any debt due by a directors (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);
  (ii) invest, otherwise than in trust securities, (the amount of compensation received by the company in respect of the compulsory acquisition, after the 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 ;
  (iii) borrow monies where the amount borrowed together with monies already borrowed by the company apart from the temporary loans obtained from the company's bankers in the ordinary course of business, exceeds the aggregate of the paid up capital of the company and its free reserves ; and
  (iv) contribute amounts to charitable and other funds, not related to the business of the company or the welfare of the employees, the aggregate whereof exceeds in a financial year Rs. 50,000 or 5% of the average net profit, during the three financial years immediately preceding, whichever is greater.

(c) Section 293A deals with prohibition and restriction regarding political contributions. According to this section, a government company or any other company which has been in existence for less than three years cannot contribute any amount directly or indirectly to any political party or for any political purpose to any person. In other cases, contribution should not exceed 5% of average net profits in any financial year determined in accordance with the provision of sec. 349 and 350 during the three immediately preceding financial years.

(d) Section 293B permits the Board and other person to make contributions to the National Defence Fund to any extent as it thinks fit.

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Previous years Questions

Q. No. 3: As a Statutory Auditor, how would you deal with the following? Apex Ltd., a well reputed manufacturing public limited company has made a contribution of Rs. 2.5 lacs during the financial year ended 31.3.09 to a political party for running a school, situated in the village, where most of the workers of the company reside. It is admitted that the benefit of the school is mostly for the children of the workers of the company. The company has not made any profits in the last four years.

[Nov. 06 (4 Marks)]*

Answer: Company has violated the provisions of Sec. 293A as it has contributed Rs. 2.5 Lacs to a political party inspite of the fact that company has not earned any profit in last four years. Hence auditor need to qualify his report stating the said violation.

PAYMENT OF DIVIDEND

Sources of Dividend: As per Sec. 205, dividend can be declared out of followings:

(a) current year profits for that year arrived at after providing for depreciation, or

(b) profits of any previous financial year or years arrived at after providing for depreciation and remaining undistributed, or

(c) moneys provided by the Central Government or a State Government in pursuance of a guarantee given by that Government .

Provisions for depreciation

(a) Before declaring or paying dividend, the company should provide depreciation for every financial year.

(b) If the company has incurred any loss in any previous financial year or years, 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.

(c) The Central Government may allow any company to declare dividend for any financial year without providing for depreciation.

Compulsory transfer to reserves:

As per Sec. 205(2A), before declaration and payment of dividend, a company is required to transfer such percentage of profits for the year to reserves not exceeding 10% as may be prescribed.

Rule 2 of Companies (Transfer of Profits to Reserves) Rules, 1975 provides that no dividend shall be declared or paid by a company for any FY out of the profits for that year arrived at after providing for depreciation in accordance with the provisions of Sec. 205(2) except after the transfer to reserves of the company of a percentage of its profits for that year as specified below:

- Not less than 2.5% of the current profits, if the proposed dividend exceeds 10% but not 12.5% of the paid up capital
- Not less than 5% of the current profits, if the proposed dividend exceeds 12.5% but not 15% of the paid up capital
- Not less than 7.5% of the current profits, if the proposed dividend exceeds 15% but not 20% of the paid up capital
- Not less than 10% of the current profits, if the proposed dividend exceeds 20%

Transfer of higher percentage of profits to reserves

A company can make a transfer of more than 10% to reserves voluntarily provided it ensures the minimum distribution specified in Rule 3 of the Companies (Transfer of Profits to Reserves) Rules, 1975. The minimum distribution is the rate of dividend equal to the average of the rates of dividend for the last 3 financial years. Where, the net profits after tax for the financial year are lower by 20% or more than the average net profits after tax of the last two financial years, it will not be necessary to ensure the minimum distribution for making a higher transfer to reserve. Where no dividend is declared, the transfer to reserves should be lower than the average amount of dividends declared during the last three financial years.

Declaration of dividend out of reserves:

Rule 2 of Companies (Declaration of Dividend out of Reserves) Rules, 1975 provides that in the event of inadequacy or absence of profits in any year, a company may declares dividend, out of the accumulated profits earned by it in previous years and transferred to reserves, subject to the following conditions:

(a) Rate of dividend shall not exceed the average of the rates at which dividend was declared by it in 5 years immediately preceding that year or 10% of its paid up capital, whichever is less;

(b) The total amount to be drawn from the accumulated profits earned in previous years and transferred to reserves shall not exceed an amount equal to one tenth of the sum of its paid up capital and free reserves and the amount so drawn shall first be utilised to set off the losses incurred in the financial year before any dividend in respect of preference or equity shares is declared; and

(c) The balance of reserves after such drawal shall not fall below 15% of its paid up share capital.

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DECLARATION OF INTERIM DIVIDEND

According to Section 2 (14A) dividend includes any interim dividend. Therefore, the procedures which are applicable to final dividend also applies to any interim dividend. Accordingly, like final dividend, interim dividend shall be considered as debt once declared and, therefore, cannot be revoked. The Board of directors may declare interim dividend and the amount of dividend including interim dividend shall be deposited in a separate bank account within five days from the date of declaration of such dividend.

Declaration of interim dividend is ordinarily based on the performance of the company. Quite often the advice of the auditor is sought before declaring an interim dividend. When this is done, the auditor should suggest that interim accounts should be prepared to ascertain the amount of profits that has been made, and the profits so computed must be sufficient for the declaration of dividend after making appropriate provisions for depreciation, compulsory transfers to reserves, bad debts and other contingencies.

TIME LIMIT FOR PAYMENT

As per Section 207, a company which has declared dividend to the shareholders should make the payment within 30 days from the date of its declaration.

The term payment implies the posting of dividend warrant irrespective of the fact whether the shareholder has received it or not. Failure to post dividend warrant within 30 days, constitutes an offence under the Act.

The penalty for the default is punishable with simple imprisonment for a term which may extend to three years and shall also be liable to a fine of Rs. 1,000 for every day during which such default continues and the company shall be liable to pay simple interest at the rate of 18% pa. during the period for which such default continues:

Unpaid or unclaimed dividend (section 205A)

Dividend declared but not paid or claimed within 30 days from the date of declaration, is required to be deposited in a special account in any scheduled bank, to be called "Unpaid Dividend Account of___ Company Limited/Company (Private) within *7* days from the date of expiry of the said period of 30 days.

Payment of unpaid or unclaimed dividend (section 205B)

Any money transferred to the unpaid dividend account of a company which remains unpaid or unclaimed for a period of 7 years from the date of such transfer shall be transferred by the company to the Investor Education and Protection Fund established.

Investor Education and Protection Fund:

Sec. 205C of the Companies act, 1956 empowers the Central Government to establish a fund known as Investor Education and Protection Fund. The purpose of this fund is to utilize the money for the promotion of investor awareness and protection to the interests of the investors.

The amount that are required to be credited in this fund are :

(a) amounts in the unpaid dividend accounts of companies;
(b) the application moneys received by companies for allotment of any securities and due for refund;
(c) matured deposits with companies;
(d) matured debentures with companies;
(e) the interest accrued on the amounts referred to in clauses (a) to (d);
(f) grants and donations given to the Fund by the Central Government, State Governments, companies or any other institutions for the purposes of the Fund; and
(g) the interest or other income received out of the investments made from the Fund;

Provided that no such amounts referred to in clauses (a) to (d) shall form part of the Fund unless such amounts have remained unclaimed and unpaid for a period of seven years from the date they became due for payment. After lapse of seven years, a person can not claim the money against the company or the fund.

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Previous Years Questions

Q. No. 4: State the salient features of Investor's Education and Protection Fund. [May 04 (8 Marks)]

Q. No. 5: A company has paid interim dividend at 10% based on its half-yearly performance while at the end of the year suffered a net loss. How you will deal with the matter in your audit report as a statutory auditor? [Nov. 04 (4 marks)]

Answer: In the present case, the company has suffered a net loss at the end of the year, which signifies that the directors have not calculated the performance of the company about the second half of the year accurately. Hence, if the company had a sufficient balance in the P & L Account as at the beginning of the year, the interim dividend paid may be adjusted against the same. But at the same time the balance had also to be sufficient to transfer the relevant amounts to reserves. In this situation, auditor need not report anything.

However, if balance in P & L A/c was not available, the dividend may also be paid out of reserves. In that situation, maximum 10% dividend is allowed.

If, however, there is no balance in the profit and loss account nor any reserves were available, the dividend would be clearly paid out of capital. Under the circumstances, the auditor would have to qualify his report mentioning the fact that the dividend having been paid out of capital.

Q. No. 6: As a statutory auditor, how would you deal with the following: ABC Ltd. having a paid up capital of Rs. 1 crore earned as total net profit of Rs. 1 crore for the years 2005-06 to 2007-08. The Company did not declare any dividend nor transferred any amount to Reserves for these years. The entire profit was retained in the Profit & Loss Account.

In 2008-09, the company made a profit of Rs. 20 lacs. The company also proposed in 2008-09 to declare dividend @25% out of accumulated profits. [May 06 (4 Marks)]*

Answer: As the rate of dividend exceeds 20% of the paid up share capital, company is required to transfer at least 10% of current profit to reserves as per the requirements of Companies (Transfer of Profit to Reserves) Rules, 1975. It resulting into deficiency of Rs. 7 lacs in the current profit for payment of dividend out of profits that could be available for the purpose of distribution of dividend.

However, the company, can cover the said deficiency of profit out of its accumulated profits. Hence the company can declare the dividend of Rs. 25 lacs for the year 2008-09.

Q. No. 7: As an auditor, how would you deal with the following? The management of a limited company states that proposed dividend does not represent a liability and hence no provision need to be made-Comment. [May 07 (4 Marks)]*

Answer: As per "Guidance Note on Liabilities", issued by ICAI, proposed dividend does not represent a liability, nor does it amount to a provision, pending the approval of the share holders in the general meeting.

However as per Schedule VI of Companies act, 1956, proposed dividend is required to be shown under Current Liabilities and Provisions. It does not mean that the proposed dividend becomes a liability or a provision. Part 1 of Schedule VI that prescribes the form of balance sheet requires 'proposed dividend' to be shown under Provisions and Part II of the same Schedule requires specific disclosure of the proposed dividend.

Hence it is recommended, that if no appropriation is made, shareholders attention should be drawn to such fact and the amount should be quantified. The fact that provision for proposed dividend has not been made should be disclosed by means of a note in the accounts. The auditor should refer to the note in his report and make his report subject thereto.

Q. No. 8: As a Statutory Auditor, how would you deal with the following: While adopting the accounts for the year, the Board of Directors of Sunrise Ltd. decided to consider the Interim Dividend declared @15% as final dividend and did not consider transfer of Profit to reserves. [May 08 (4 Marks)]*

Answer: As per Sec. 2(14A), dividend includes interim dividend. Therefore, the procedures which are applicable to final dividend also applies to any interim dividend, hence the company is required to provide for depreciation as required u/s 205 and comply with the companies (Transfer of Profit to Reserve Rules, 1975) before declaration of interim dividend. As per Companies (Transfer of Profit to Reserve) Rules, 1975, where the dividend proposed exceeds 12.5% but does not exceed 15 % of the paid-up capital, the amount to be transferred to the reserves shall not be less than 5 % of the current profits. If the company does not transfer any profit to reserves, it can pay interim dividend not exceeding 10% of the paid up capital. In the instant case, the Board has decided to pay interim dividend @15% of the paid-up capital without transfer of profit to reserves.

Under the present circumstances, the statutory auditor should qualify his report stating the facts.

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