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Education
for All

CORPORATE ACCOUNTING AND AUDITING

COURSE CODE: SGB24CM204MC
Bachelor of Commerce (Honours)
Major Course
Self Learning Material

SREENARAYANAGURU OPEN UNIVERSITY

The State University for Education, Training and Research in Blended Format, Kerala

Vision

To increase access of potential learners of all categories to higher education, research and training, and ensure equity through delivery of high quality processes and outcomes fostering inclusive educational empowerment for social advancement.

Mission

To be benchmarked as a model for conservation and dissemination of knowledge and skill on blended and virtual mode in education, training and research for normal, continuing, and adult learners.

Pathway

Access and Quality define Equity.

Corporate Accounting and Auditing

Course Code: SGB24CM204MC

Semester - IV

Four Year Undergraduate Programme
Bachelor of Commerce (Honours)
Major Course
Self Learning Material

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CORPORATE ACCOUNTING AND AUDITING

Course Code: SGB24CM204MC
Semester- IV
Major Course
Bachelor of Commerce (Honours)

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MESSAGE FROM VICE CHANCELLOR

Dear Learner,

It is with great pleasure that I welcome you to the Four Year BCom Programme offered by Sreenarayanaguru Open University.

Established in September 2020, our university aims to provide high-quality higher education through open and distance learning. Our guiding principle, 'access and quality define equity', shapes our approach to education. We are committed to maintaining the highest standards in our academic offerings.

Our university proudly bears the name of Sreenarayanaguru, a prominent Renaissance thinker of modern India. His philosophy of social reform and educational empowerment serves as a constant reminder of our dedication to excellence in all our academic pursuits.

The Four Year BCom Programme covers all relevant areas aligned with modern business practices and economic principles. We have incorporated the latest trends in commercial studies to ensure a comprehensive and up-to-date curriculum. Moreover, the programme encompasses flexible options for learners to choose from a range of Ability Enhancement Courses, Multi-disciplinary Courses, Value Added Courses, and Skill Enhancement Courses, complemented by discipline-oriented Advanced and Additional Advanced Courses.

Our teaching methodology combines three key elements: Self Learning Material, Classroom Counselling, and Virtual modes. This blended approach aims to provide a rich and engaging learning experience, overcoming the limitations often associated with distance education. We are confident that this programme will enhance your understanding of commercial principles and practices, preparing you for various career paths and further academic pursuits.

Our learner support services are always available to address any concerns you may have during your time with us. We encourage you to reach out with any questions or feedback regarding the programme.

We wish you success in your academic journey with Sreenarayanaguru Open University.

Best regards,

Dr. Jagathy Raj V.P.
Vice Chancellor
Sreenarayanaguru Open University

01-01-2026

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BLOCK

Accounting for Shares

Unit 1 Introduction to Share Capital

Learning Outcomes

After completing this unit, the learner will be able to:

- ◊ define the concept of shares and identify Classes of Shares
- ◊ distinguish types of capital, Reserve capital & Capital reserve
- ◊ comprehend placement of shares – private, IPO, Rights, Bonus, ESOP, etc
- ◊ record in books of accounts the issue of shares at par or premium for consideration in cash in installments, forfeiture & reissue, or consideration other than cash
- ◊ explain procedures of issue and conditions to be fulfilled in terms of minimum subscription and how can it be ensured

Prerequisite

A young entrepreneur, Aarav, who dreams of starting a company called Sunrise Industries Ltd. but does not have enough money to begin. He realises that by issuing shares to the public, he can collect funds from many investors, and this pool of money becomes the company's share capital. As he learns more, he discovers that share capital moves through different phases such as authorised, issued, subscribed, and paid-up capital, each showing how much money the company can raise and actually receives. He also finds that companies issue different types of share capital to meet various investor needs. When Aarav finally offers shares to the public, people apply for them in a process called subscription of shares. However, the company can start business only if it collects a minimum subscription, the required amount of money needed to proceed. When Sunrise Industries successfully receives this minimum subscription, Aarav's dream moves one step closer to reality, showing how share capital helps transform ideas into real businesses.

Keywords

Equity/ IPO, ESOP, Price bands, Forfeiture and re-issue of Shares, Buyback, and redemption. Cash dividends and scrip dividends (Bonus issue), Rights issue, minimum subscription

Discussion

1.1.1 Share Capital

As we know, people venture out into business either themselves or joining hands with others. Self-entry into business as a 'sole proprietorship' and jointly entering into an agreement called 'partnership' with a few known persons to set up a business for sharing the profits or losses therefrom are characterized by the unlimited liability of owners. By unlimited liability, we mean that the business liabilities are not confined to the business assets. It extends over to the personal assets of owners. In short, the owner, either the sole trader or each partner in a partnership firm, is personally liable to pay off his business debts using his wealth in case business assets are insufficient to pay off such obligations. In contrast, the limited liability of owners is one distinctive feature of joint stock companies, yet another form of business organization.

A Company is an artificial person created by law with a separate legal entity, where owners are not personally liable to pay off business debts from their private assets. It is a voluntary association of people where the owners pool their resources by contributing towards the capital as members. Thus, the total capital of a company is divided into several pieces, each piece called a share with distinctive value.

For example, the total capital of a company is Rs. 1, 00, 000 may be divided into 1, 000 shares, each share having a distinct value of Rs. 100 each (1, 000 shares x 100 Rs = Rs. 1, 00, 000) or 10, 000 shares of Rs. 10 each (10, 000 shares x 10 Rs = Rs. 1, 00, 000). Or even 1, 00, 000 shares of Rs... 1 each (1, 00, 000 shares x 1 Re. = Rs. 1, 00, 000). Those who contribute to the share capital of the company as members are contributors, who are known as shareholders of the company. Thus, each share has a value known as face value or par value, whether it be Rs. 10, Rs. 100, or Re. 1 Per share. Technically, the liability of a shareholder is limited to the face value of shares held by him. In its simplest sense, a shareholder of 100 shares of Rs. 10 each will have a liability, limited to Rs. 1000 (100 shares x Rs. 10 each = Rs. 1000). Hence, he is not liable to pay anything more than Rs. 1, 000 even if the business debts of the company amount to millions of rupees.

It may be recalled that companies may either be incorporated as a private limited company or a public limited company. A private limited company, by its nature, has to limit its shareholders to persons who know each other such as family members, friends, or associates. The Companies Act itself restricts private limited companies from inviting the general public to buy their shares or having an unlimited number of shareholders. On the contrary, public limited companies are free of such restrictions and can invite the general public to buy rather than subscribe to any number of shares issued by them. The body corporates, incorporated or registered as public limited companies, often approach the general public inviting offers from them to buy shares. Since the company is directly approaching the general public with newly created instruments such as shares or debentures, this market is known as the 'primary market.'

1.1.2 Share Vs Stock

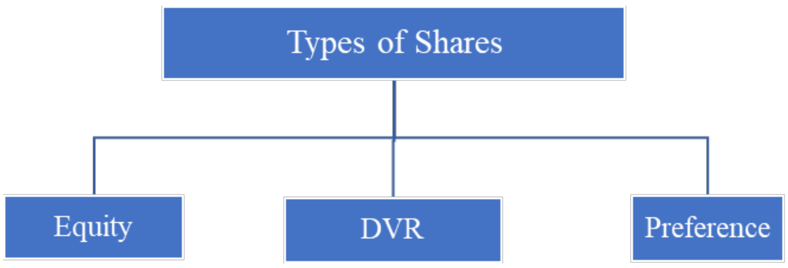
Shares represent the smallest unit of ownership of any company denoting the proportion of ownership in the company. For example, a person who bought 10000 shares of a company that has issued 1, 00, 000 shares is said to be a 10 percent shareholder since he holds 10% of the shares issued by the company. Shares are issued at par or premium or theoretically at a discount.

Stocks are the collection of shares of a single company or multiple companies. It represents the holder's part-ownership in one or several companies. For example, a shareholder who holds 10000 shares of a company having 100000 shares can consider his 10000 shares as one stock representing 10% ownership in the company. Stock may denote shares of one company or a collection of shares of several companies. Stocks are not issued but are conversions of shares of any member into a fund.

While shares of a company have equal value, stocks of one company may or may not have equal value depending on the denomination of shares that have been converted into stock. Since on-listing companies change shares into stock, the share market came to be popularly known as the stock market. Conversion of shares into stock enabled buying and selling in lots known as market lots, which is no longer significant since shares can be bought and sold in any denomination online making market lots a thing of the past.

1.1.3 Types of Shares

Shares represent ownership in a company. In common parlance, shares mean equity shares in India, since it is not mandatory to issue preference shares. Currently, companies in India can issue equity shares, shares with differential voting rights, and preference shares



1.1.3.1 Equity Shares

Equity shares are shares that represent true ownership in companies and are also called ordinary shares. The holders of the equity shares are entitled to dividends that are shared in the profits of the company. They are also entitled to voting rights which enables them to exercise their ownership rights. Equity shares are listed on the stock exchanges which enables buying and selling between investors. This increases liquidity to investors due to the capability of equity shares of any-time convertibility into cash. A high demand for equity shares of a company in stock markets can fetch a higher market price for the equity shareholders. It is in this context that we need to examine why people buy equity shares offered by companies. The merits and demerits of equity shares may be summarised as

Merits:

i. It carries voting rights enabling equity shareholders to have controlling power in companies.

ii. Equity shareholders are real owners of the company and are entitled to any residue in profits or assets after the claims of all other stakeholders are settled.

iii. It carries dividends that are not fixed. Dividends on equity shares vary according to the level of profits. Hence, there is a higher return potential if the company makes more profit.

iv. Equity shares of listed companies are traded in stock exchanges. It can be sold any time the shareholders wish and hence there is a ready market and liquidity to shareholders.

v. The market price of the equity shares is dependent on fundamentals namely company, industry, and economy factors. A high market price enables shareholders to derive capital gains (selling price – cost of buying) besides the dividends that have been received during the period of holding.

De-merits:

i. The voting rights and controlling power are purely technical in the sense that shareholders with small holdings do not have much voice in general meetings and day-to-day management of the company.

ii. Being the real owners, equity shareholders are prone to risk associated with low profits and prospects of the company. They have to end up with no dividends if the company is not profitable. Similarly, in the event of winding up of the company, they have to be contented with whatever is left, if any, after settlement of all other claims.

iii. The market prices of equity shares are vulnerable to wide fluctuations. Hence, the possibility of disaster or a fall in market values exposes shareholders to risk and uncertainty.

1.1.3.2 Shares with Differential Voting Rights

Shares with Differential Voting Rights, popularly known as DVR, is a modified variant of equity shares that companies may generally issue to raise capital without losing the controlling power of the existing management. The differential rights concern voting power and dividends. Generally, one equity share carries one vote, but in the case of differential voting rights, one share carries more than or less than one voting right. Usually, equity shares with fewer voting rights carry a higher rate of dividend. However, equity shares with higher voting rights may also be issued, particularly to promoters, key managerial persons, Managing directors, etc. In such cases, the shares may carry a lesser rate of dividend. With voting rights different from equity shares, shares with differential voting rights (DVR) issued to the general public may trade at lower prices in the stock exchange despite higher dividends.

Equity shares with differential voting rights should only be issued with authorization by way of a special resolution passed at the general meeting of the shareholders. Further, the shares with superior voting rights must have been held for at least 6 months before the filing of the red herring prospectus. A red herring prospectus is a preliminary prospectus filed by a company before a regulatory commission such as the Securities Exchange Board of India (SEBI) which may be incomplete and subject to change. It does not state the price or size of the issue, which may be subsequently stated in the final prospectus.

1.1.3.3 Preference Shares

Preference Shares are yet another category of shares that are issued by companies in India. Preference shareholders enjoy two preferences over equity shareholders. They are

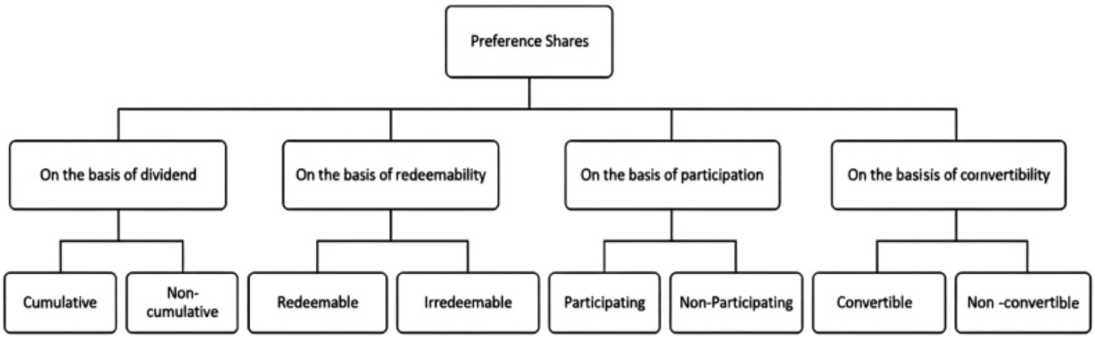
i. **Preference in the matter of getting dividends** : These shares give shareholders the right to dividends ahead of the equity shareholders.

ii. **Preference in the matter of getting repayment of capital** : Though preference shares do not carry voting rights, the preference shareholders have preference in getting repayment of capital in the event of winding up of the company.

Thus, preference shares have a prior claim on the profits and assets of the company. However, the dividend on preference shares is fixed. The preference shareholders will not benefit from the prosperity of the company since they are not eligible for higher dividends, as equity shareholders get when profits are high.

Preference shares or preferred shares/ stocks are shares that extend a fixed dividend, though they do not come with voting rights. Different types of preference shares that are distinct in features and associated benefits are issued by companies. Even though all types of preference shares are not entitled to voting rights, preference shareholders are owners of the company though in a partial sense only.

Based on their dividends pay-out, maturity period or redeemability, participation in profits and assets, and convertibility preference shares may be classified as follows.



a. Cumulative and Non-cumulative Preference Shares

Cumulative preference shares are preference shares on which dividends get accumulated. If the company does not declare a dividend on preference shares in a particular year such unpaid dividend is accumulated and carried forward to subsequent years. Eventually when the company decides to pay dividends then it has to first pay the accumulated dividend of previous years to the preference shareholders before paying any dividend on ordinary shares. The holders of cumulative preference shares thus do not lose the right of preference dividend of any year. They are assured of getting all the unpaid dividends of past years if the company pays dividends in any subsequent year.

Non-Cumulative Preference Shares are preference shares on which the unpaid dividend does not get accumulated and the preference shareholders lose the right to dividend for the past year(s). If in any year the company fails to pay a preference dividend, such dividend is lost forever as far as the holders of non-cumulative preference shares are concerned. In simple words, the non-cumulative preference shareholders are not entitled to receive any dividend arrears for the past unpaid years.

b. Redeemable and Irredeemable Preference Shares

Redeemable preference shares are preference shares that have a fixed period of life. They are redeemed after a definite period stated by the company at the time of their issue itself. Redemption is the process of returning the capital and buying back the shares. As per the predetermined redemption clause stated at the time of issue, the company pays back the preference shareholders to buy back the redeemable preference shares. The redemption price is pre-determined and stated at the time of issue of redeemable preference shares itself. Redemption at par means the price payable on redemption is simply the face value collected by the company at the time of issue. On the other hand, redemption at a premium means that the company agrees to repay the face value collected together with an agreed premium on redemption of preference shares. The issuing company can redeem the redeemable preference shares any time before the expiry of its specified life.

Irredeemable preference shares do not have a fixed period of life. They are perpetual and are only redeemed at the time of liquidation of the company. As long as the company is in existence, such non-redeemable preference shares continue to exist making it a permanent liability to the company. Since irredeemable preference shares do not offer flexibility to the issuing company to buy back the shares any time they desire, such shares are not as popular as redeemable preference shares. Companies are not allowed to issue irredeemable/ perpetual preference shares under the Companies Act, 2013.

c. Participating and Non-participating Preference Shares

Participating preference shares are shares that give the right to their holders to participate in surplus profits and assets. The holders of participating preference shares thus participate in profits remaining after paying fixed preference dividends and equity dividends of any year. Similarly, in the event of winding up of the company, they are entitled to a share of a surplus of assets remaining after payment of all liabilities including the equity capital. Hence, participating preference shares allow holders to participate on the same footing as the holders of equity shares as far as a surplus of profits or assets is concerned.

Non-Participating Preference Shares do not grant its holders any right to participate in surplus profits or assets of the company. The holders of these shares do not enjoy rights over and above their fixed entitlements of dividends and capital repayment.

d. Convertible and Non-convertible Preference Shares

Convertible preference shares are shares that are convertible to equity shares at the option of the shareholders on the expiry of a definite period. Such preference shares may either be partially or fully converted into equity shares if the preference shareholders wish to do so, after holding it for a specified period.

Preference shares that do not qualify for conversion into equity shares are called non-convertible preference shares. Such shares will continue to remain as preference shares in the hands of shareholders until its maturity if any or perpetually till the liquidation or winding up of the company.

1.1.4 Phases of Capital

The share capital of the company may be raised at different stages. Though the capital that can be raised is more, the company may decide to collect it in part as and when capital requirements arise. In this section, we will discuss the terms relating to various phases of capital and how one differs from the other.

1.1.4.1 Authorised Capital

Companies are required to mention the capital which it is authorized to raise from the public in their memorandum of association, at the time of registration. 'Authorised Capital' refers to the maximum amount of capital that the company is authorized to raise from the public, though such maximum may be increased by amendments to the memorandum of association later. It is the capital with which the company is registered and is also referred to as 'Registered Capital'.

For example, a company may be registered with an authorized capital of say 1, 00, 000 equity shares of Rs. 10 each aggregating to an authorized capital of Rs. 10, 00, 000. This is the maximum amount of capital the company can raise in its lifetime unless it has been increased by amending the memorandum of association.

1.1.4.2 Issued Capital

Issued capital is that part of the authorized capital which is issued to the public for subscription. Though the company is authorized to raise a higher amount of capital, it may not raise it altogether. A part of such authorized capital may only be issued at a point in time. 'Issued Capital' is the nominal value of the shares which are offered to the public for subscription.

For example, if a company has an authorized capital of 1, 00, 000 equity shares of Rs. 10 each aggregating to Rs. 10, 00, 000 and if they have issued 50, 000 equity shares of Rs. 10 each for public subscription, then the issued capital will be 50, 000 equity shares of Rs. 10 each aggregating to Rs. 5, 00, 000.

	Rs
Authorised Capital	
1,00,000 Equity shares of Rs. 10 each	10,00,000
Issued Capital	
50,000 Equity shares of Rs. 10 each	5,00,000

It may be noted that issued capital is always less than or equal to the authorized capital and in no instance can issued capital exceed authorized capital. Issued capital and authorized capital will be the same if all shares authorized are issued by the company for public subscription.

1.1.4.3 Subscribed Capital

A part of the issued capital may not be taken up by the public. In that case, the value of number of shares subscribed for by the public constitutes the subscribed capital. 'Subscribed capital' is the portion of issued share capital that is taken up or subscribed by the public. When all the shares that have been issued are not taken over by the public, subscribed capital will be lesser than the issued capital.

For example, if a company has an authorized capital of 1, 00, 000 equity shares of Rs. 10 each aggregating to Rs. 10, 00, 000 and if they have issued 50, 000 equity shares of Rs. 10 each for public subscription, and if the public has only offered to subscribe 45, 000 equity shares of Rs. 10 each, then the subscribed capital will be 45, 000 equity shares of Rs. 10 each aggregating to Rs. 4, 50, 000.

	Rs
Authorised Capital	
1,00,000 Equity shares of Rs. 10 each	10,00,000
Issued Capital	
50,000 Equity shares of Rs. 10 each	5,00,000
Subscribed Capital	
45,000 Equity shares of Rs. 10 each	4,50,000

It may be noted that subscribed capital is always less than or equal to the issued capital and in no instance can subscribed capital exceed issued capital. Subscribed capital and issued capital will be the same if all shares issued are subscribed for by the public.

1.1.4.4 Called-Up Capital

It is not always necessary for the company to collect the entire par value and premium if any in a lump sum. The total amount payable by the subscriber may be collected in instalments by the company. In such cases, subscribers are required to pay only what the company has asked so far. The amount per share that has been asked by the company is referred to as the called-up amount. The company may allow as many installments as they decide. The amount payable by the subscriber on an equity share of Rs. 10, may be collected in four instalments of Rs. 3, Rs. 2, Rs. 2.50, and Rs. 2.50 at different intervals of time. In such cases, the first instalment is called the share application, the second instalment is the share allotment and the subsequent installments are referred to as calls like first call, second call, etc. Whether it be application money allotment money or call money, the amount that has been requested to be paid is referred to as the called-up amount.

'**Called-up capital**' is the portion of the face value of the shares that the company has demanded to pay and the shareholders are called upon to pay. When the whole par value has not been demanded to be paid by the company the capital will be lesser than the subscribed capital.

For example, if a company has an authorized capital of 1, 00, 000 equity shares of Rs. 10 each aggregating to Rs. 10, 00, 000 and if they have issued 50, 000 equity shares of Rs. 10 each for public subscription, and if the public has only offered to subscribe 45, 000 equity shares of Rs. 10 each, then the subscribed capital will be 45, 000 equity shares of Rs. 10 each aggregating to Rs. 4, 50, 000. However, if the company has so far collected Rs. 3 per share on application Rs. 2 per share on allotment and Rs. 2.50 on the first call, then only Rs. 7.50 (3+2+2.50) has been called up. Hence the called-up capital will be 45, 000 equity shares of Rs. 10 each, Rs. 7.50 called up aggregating to Rs. 3, 37, 500 (45, 000 x 7.50 = 3, 37, 500).

	Rs
Authorised Capital	
1,00,000 Equity shares of Rs. 10 each	10,00,000
Issued Capital	
50,000 Equity shares of Rs. 10 each	5,00,000
Subscribed Capital	
45,000 Equity shares of Rs. 10 each	4,50,000
Called-Up Capital	
45,000 Equity shares of Rs. 10 each, Rs.7.50 called up	3,37,500

It may be noted that called-up capital is always less than or equal to the subscribed capital and in no instance can called-up capital exceed subscribed capital. Called-up capital and subscribed capital will be the same if all shares subscribed are fully called up for by the company.

1.1.4.5 Paid-up Capital

The amount paid by the shareholders is known as Paid-up Capital. '**Paid-up**' capital is that portion of the called-up capital which has been received from the shareholders. When all the shareholders have paid all the call amount, the called-up capital is the same as the paid-up capital.

The difference between the called-up capital and paid-up capital arises due to the calls in arrears. Calls in arrears refer to that amount called up by the company but have not been paid by any of the shareholders within the specified time allowed.

In the example cited above, if certain shareholders holding 800 shares altogether have failed to pay the last instalment namely the first call of Rs.2.50, then calls in arrears amount to Rs. 2000 (800 x Rs. 2.50 = Rs. 2, 000). In that case, the paid-up capital will be Rs 3, 35, 500 (Rs. 337500- Rs. 2,000).

	Rs.	Rs
Authorised Capital		
1,00,000 Equity shares of Rs. 10 each		10,00,000
Issued Capital		
50,000 Equity shares of Rs. 10 each		5,00,000
Subscribed Capital		
45,000 Equity shares of Rs. 10 each		4,50,000
Called-Up Capital		
45,000 Equity shares of Rs. 10 each, Rs.7.50 called up		337500
Paid-Up Capital		
45,000 Equity shares of Rs. 10 each, Rs.7.50 called up	3,37,500	
Less Calls in Arrears (800 shares @ Rs.2.50 each)	2,000	3,35,500

It may be noted that Paid-up capital is always less than or equal to the called-up capital and in no instance can paid-up capital exceed called-up capital. Paid-up capital and called-up capital will be the same if the amount called-up is fully paid by the shareholders.

1.1.5 Reserve Capital and Capital Reserve

Reserve Capital is that part of the uncalled capital that is kept as a reserve to be called upon and collected to meet exigencies. It cannot be called up except in the approved circumstances like liquidation. It is noteworthy that reserve capital is not a portion of authorized capital that has not been issued, since in the event of an unforeseen circumstance like winding up, such shares will not be subscribed if issued. However, in the case of issued and subscribed capital, the shareholders are legally obliged to pay the calls and it is prudent to reserve a call on subscribed capital so that such reserved capital can be called up and collected to meet unforeseen exigencies like liquidation of the company. It is created from uncalled capital though it is neither mandatory to create it nor disclose it in the balance sheet. It can only be used at the time of winding up and cannot be used to write off capital losses.

Capital reserve, on the contrary, has nothing to do with the capital authorized, issued, or subscribed. It refers to the reserve created from profits that have not been earned through regular operations of the business. Capital Reserve refers to mandatory reserve created from capital profits, which is not available for distribution as dividends. It may be recalled that profits may be revenue profits or capital profits. While revenue profits are earned profits from the operations of the company, capital profits are non-recurring or irregular profits arising from the sale of fixed assets or issue of shares and debentures. Capital reserves are created from capital profits and are hence not free for the distribution of dividends.

Test your knowledge

Imagine a company that has been registered with a capital of 10,000 equity shares of Rs. 100 each. What will be its

i. Authorised Capital
   .... Equity Shares of Rs......each = Rs. ....

ii. Issued Capital if it offers 5,000 shares for subscription currently
   .... Equity Shares of Rs.......... each = Rs. ....

iii. Subscribed Capital if 4,500 shares are only subscribed for by public
   .... Equity Shares of Rs.......... each = Rs. ....

iv. Called up Capital, if the company has not yet called up Rs. 50 per share out of the par value per share of Rs. 100.
   .... Equity Shares of Rs.......... each, Rs...... called up
   = Rs. ....

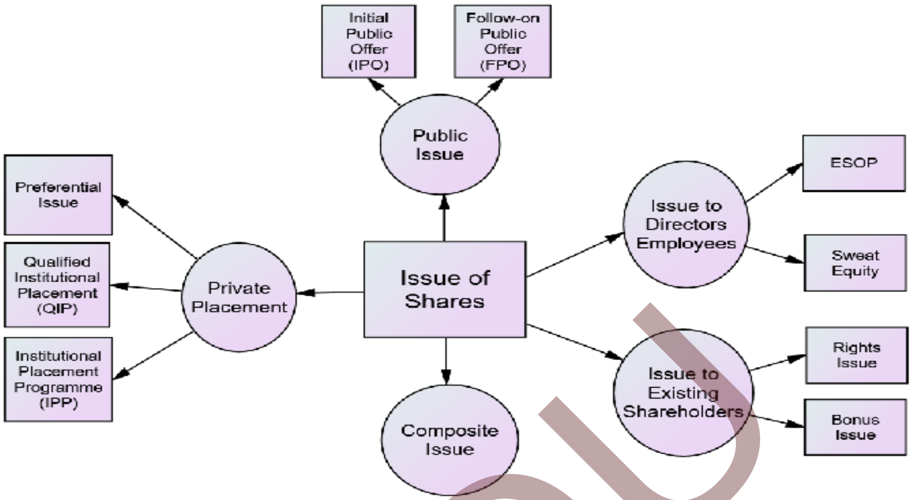
v. Paid up Capital if holders of 600 shares failed to pay allotment money of Rs. 25 per share out of the called up Rs. 50 per share.
   .... Equity Shares of Rs.......... each,
   Rs...... called up, = Rs. ....

Less calls in arrears .... Shares @ Rs.... = Rs....................

= Rs ....

1.1.6 Issue of Shares

Issue of Shares is the process in which companies allot new shares to shareholders, either individuals or corporations. There are several ways in which the shares of a company can be issued which include private placement, public issue, issue to directors/ employees, issue to existing shareholders, and composite issue.



1.1.6.1 Private placement

A private placement is a sale of shares/ stock or bonds to pre-selected investors and institutions rather than on the open market. Private placements are adopted by start-up companies who are in quick need of funds, as an alternative to an initial public offering (IPO). A company that has not so far approached the market seeking to raise capital for expansion may depend on a private placement for the immediate need of capital.

Private Placement of Shares refers to the sale of shares of the company to the investors and institutions that are selected by the company which generally includes banks, mutual fund companies, wealthy individual investors, insurance companies, etc rather than issuing it in the open market for the public as a whole. In certain cases, a portion of the issued capital may be reserved for private placement while the balance is made available to the public in a public issue. The private placement of shares to a selected group of investors such as mutual funds, banks, insurance companies, pension funds, etc. may take either of the following forms.

a. Preferential - Issue:

When a publicly listed company allots shares to a selected group of investors such as individuals, venture capitalists, or other companies on a preferential basis, the private placement is referred to as a preferential Issue.

b. Qualified Institutional Placement (QIP)

Qualified Institutional Placement or QIP refers to the process of a listed company offering equity shares or non-convertible securities to a qualified institutional buyer, such as mutual funds, venture capital funds, public financial institutions, insurance funds, scheduled commercial banks, pension funds, etc. for sale or to raise capital.

c. Institutional Placement Programme (IPP)

If shares are allotted to the QIBs only, to achieve minimum public shareholding and not for reselling to the public it is referred to as an Institutional placement program (IPP). In such placements listed company makes a follow-on offer of equity shares or the promoters offer for the sale of shares. In an Offer for Sale, promoters of a company dilute their stake by selling their shares to Qualified Institutional Buyers (QIBs). It is noteworthy that the offer for sale by promoters is not confined to sales to QIBs but extends to sales to retail investors, companies, and foreign institutional investors.

1.1.6.2 Public Issue

Public issue refers to the raising of capital from the general public through a public offering of shares or convertible securities for sale. It is the process of companies approaching the primary market to attract new investors to subscribe to the issue of shares made by the company. In a public issue, the company invites offers for subscription from the public through a prospectus. The investors who wish to subscribe for the shares make an application to the company. The company then allots shares to them or rejects the application depending upon the volume of applications. The applicants receive a 'letter of regret' once their application is rejected or a 'letter of allotment' if they are allotted shares. The issue of shares to the public may either be an Initial Public Offer (IPO) or a Follow-on/ Further public offer (FPO).

a. Initial Public Offering (IPO)

Initial Public Offer is the sale of shares to the public for the first time. Technically, the process of inviting the general public to buy shares offered by a private limited company on its conversion to a public limited company is officially referred to as 'going public.' Since the hitherto private limited company is first time issuing shares to the general public this issue is known as an 'Initial Public Offer' or 'IPO'. However, even when a company registered as a public limited company which is not yet listed on stock exchanges issues shares for the first time it is referred to as an initial public offering or IPO.

When a company, which is presently not listed on any stock exchange, either makes a fresh issue of shares or makes an offer for the sale of its existing shares or both for the first time to the public it is known as an IPO (initial public offering). The issuer of shares thus makes an offer for new investors to enter its shareholding family which was till now confined privately to a group of people who knew each other. Through IPO, the unlisted company can go public and list its shares on the recognized stock exchanges.

b. Follow-on or Further Public Offer (FPO)

Follow-on or Further Public Offer (FPO) refers to the issue of shares by an already listed company. If the public company issues additional shares to the public for sale any time after its initial public offering, to expand its equity base or pay off debts, it is known as a Follow-on Public Offer or Further Public Offer (FPO).

1.1.6.3 Issue of shares to directors/ employees

Besides raising funds by issuing shares to owners namely shareholders, a company can issue shares to the directors/ employees as an incentive to motivate them and make them contribute better to the company. Since loyal employees are now considered to be the key factor in ensuring the success of the company, retaining them for the long term by compensating their efforts by way of issuing shares to them has become popularly accepted as workers' participation in management. Employee stock Option Scheme (ESOP) and Sweat Equity Shares are two common methods of issuing shares by companies to their directors/ officers or employees.

a. Employees Stock Option Plan (ESOP)

An employee stock ownership plan (ESOP) gives workers ownership interest in the company. It allows employees an opportunity to buy shares of the employer company usually at prices lower than the market prices.

As per Section 2(37) of the Companies Act, 2013, the employee stock option means the option provided to the directors, employees, or officers of the company or its holding or subsidiary company, which gives the right or benefit to subscribe or purchase the shares of the company at a predetermined price on a future date. The subscribed capital is raised by the issue of shares under ESOP. It is a right given to employees to exercise their option to purchase the shares at a predetermined price on a future date. The consideration for such a purchase will have to be paid in cash and the shares so obtained will not be transferable during the lock-in period as determined by the company.

b. Sweat Equity

Sweat equity shares mean shares issued by a company to its directors or employees for non-cash consideration or at a discount for making rights available like intellectual property rights providing know-how or providing any value additions in any form. Sweat equity shares refer to shares issued to directors or employees for their contribution towards the business venture. It is non-monetary and is issued to compensate for the physical labour, mental effort, inventions, technical know-how, and time contributed by the directors or employees. Sweat equity shares are directly allotted to the employees or directors, partly cash or partly noncash, free for their contributions or at a discounted price. As per Companies (Share Capital and Debentures) Rules, the sweat equity issued is subjected to a three-year lock-in period, during which it cannot be sold or transferred by its holders.

1.1.6.4 Issue of shares to existing shareholders

Every time a company needs funds for further investment, they can rely on sources of financing such as the issue of equity or preference shares, the issue of debentures, or borrowing money as long-term loans, or rely on their accumulated profits by capitalizing such retained earnings. Instead of approaching the general public or primary every time with a new issue of shares they can raise capital from existing equity shareholders by a rights issue of shares or by capitalizing profits through the issue of bonus shares to existing equity shareholders.

a. Rights Issue

A rights issue is an invitation to existing shareholders to purchase additional new shares in the company. When the company wants to raise additional funds without involving any public, it may issue the shares to its existing shareholders at a concessional price on a pre-determined date, in proportion to their existing shareholding in the company.

A rights issue is directly offered to all existing shareholders of the Company in proportion to their current holding. The company also set a time limit for the shareholder to buy the shares. Companies pursue Rights Issues as an avenue to raise funds for various reasons, ranging from expansion or acquisitions to paying down debts. As per the Companies Act the shareholders have a pre-emptive right which provides the existing shareholders the right to subscribe for any additional shares issued by the company. This right ensures that existing shareholders can ensure the current proportion of shareholding in the company. If existing shareholders are not offered the new shares and if it is given to other people, then the percentage ownership of existing shareholders in the company gets diluted. The right offered by the company may be exercised by the existing shareholders by paying money and buying such shares or the rights may simply be ignored in which case the rights get lapsed. Yet another option for existing shareholders is to renounce the right to an agreed price in favour of third parties who will pay and buy the shares from the company. A right issued may be made as an exclusive issue to existing shareholders or it may be a composite issue where it is a part of a public issue with a certain number of shares declared as a rights issue.

b. Bonus Issue

A company may convert its retained earnings partially or fully into capital by issuing shares, known as bonus shares, free to existing shareholders. Bonus shares are additional shares given free to the existing shareholders based on the number of shares held by them. The company will not collect money to raise capital from the issue of bonus shares but raises subscribed capital through the capitalization of profits. Since the profits that have been retained without giving dividends to shareholders are now used for giving free shares to existing shareholders, bonus shares are also known as scrip dividends or stock dividends. The issue of bonus shares simply increases the number of shares held by shareholders without resulting in a cash inflow to the company. However, the wealth of the shareholders increases to the extent of the market value of bonus shares received free of cost from the company. The issue of bonus shares is made out of the company's free reserves or securities premium collected at the time of the earlier issue of shares.

c. Composite Issue

A composite issue is one in which an already listed company offers shares on the public-cum-rights basis and makes concurrent allotment of the shares. Means issuing shares to existing shareholders and general public .

1.1.7 Minimum subscription

It is the minimum amount that, in the opinion of directors, must be raised to meet the needs of business operations of the company relating to:

- the price of any property purchased, or to be purchased, which has to be met wholly or partly out of the proceeds of issue;
- preliminary expenses payable by the company and any commission payable in connection with the issue of shares;
- the repayment of any money borrowed by the company for the above two matters;
- working capital;
- and any other expenditure required for the usual conduct of business operations.

It is to be noted that the 'minimum subscription' of capital cannot be less than 90% of the issued amount according to SEBI (Disclosure and Investor Protection) Guidelines, 2000 [6.3.8.1 and 6.3.8.2]. If this condition is not satisfied, the company shall forthwith refund the entire subscription amount received. If a delay occurs beyond 8 days from the date of closure of the subscription list, the company shall be liable to pay the amount with interest at the rate of 15% [Section 73(2)].

Minimum subscription refers to the minimum amount that a company should raise at the time of issuing capital. The requirement for minimum subscription applies to all companies which raise funds from the public. The company may successfully procure the amount of minimum subscription. In such circumstances, the company is allowed to retain the capital, which has been collected from the investors. Alternatively, the company may not be able to obtain the minimum subscription successfully. Hence, according to the Companies Act, there is an inadequacy in the minimum subscription. In such cases, the company should refund the application deposit. The provisions relating to minimum subscription are available in Section 39 of the Companies Act.

The Government of India observed that when public companies opted for the issue of capital, the public response may be inadequate. On account of the poor public response, the confidence of the investors in the regulatory mechanism may diminish. Hence, in keeping with the expectations of the investors, the issue of capital should be halted. Cancellation of the issue should be performed if the public does not have the minimum subscription. The objective of Section 39 is to introduce a prohibition on the allotment of securities. As per the section, the allotment should be prohibited when the minimum subscription requirement is not fulfilled.

The provisions relating to minimum subscription should be applied whether a company makes an issue of debt or equity securities. The requirement for a minimum subscription is determined through a ceiling limit. The Government of India (GoI) has fixed the ceiling limit as ninety percent. The ceiling limit should be applied to the total capital issued by the company. The company should collect at least ninety percent of the issued amount. In case the value accumulated amounts to less than ninety percent of the capital issued, the entire amount should be refunded. The value accumulated refers to the amount of capital raised through an issue.

Recap

- ◊ Share capital refers to the total amount of capital a company raisesby issuing shares to investors.
- ◊ The phases of capital include authorized capital, issued capital, subscribed capital, called-up capital, and paid-up capital.
- ◊ Reserve Capital is part of uncalled capital for winding-up situations, while Capital Reserve is created from non-operational profits and used for specific purposes.
- ◊ Shares represent ownership in a company, and their types include equity shares and preference shares.
- ◊ Equity shares carry voting rights and dividends based on profits, while redeemable preference shares have a fixed return and are repaid after a specific period.
- ◊ These are preference shares with cumulative dividends that can be converted into equity shares after a predetermined time.
- ◊ These are shares issued to employees or directors as a reward for their contributions to the company.
- ◊ ESOP allows employees to purchase company shares at a discounted price, encouraging ownership and loyalty.
- ◊ Private placement is the issuance of shares to a select group of investors rather than the general public.
- ◊ Share issues involve various methods such as public issues, rights issues, or private placements to raise funds.
- ◊ A bonus issue involves issuing additional shares to existing shareholders without any cost, derived from company reserves.

- ◊ A rights issue offers existing shareholders the opportunity to purchase additional shares before offering them to others.
- ◊ Subscription refers to the process by which investors apply for and agree to purchase shares in a company.
- ◊ This refers to the step-by-step processes involved in the issuance, subscription, and allotment of shares.
- ◊ Minimum subscription is the threshold amount of shares that must be subscribed to make the share issuance valid as per legal requirements.

Objective Questions

1. What is the primary difference between Reserve Capital and Capital Reserve?
2. Which type of shares are issued to employees at a discount to incentivize them?
3. What does ESOP stand for?
4. What is the invitation to exisitng share holders to purchase additional new shares in the company ?
5. What is the minimum subscription requirement for shares as per company law?
6. Private Placement of Shares refers to shares issued to:
7. Bonus shares are issued to:
8. Shares which have Voting Right ?
9. Convertible Cumulative Preference Shares can be converted into:
10. Right Issue of Shares is offered to:

Answers

1. Reserve Capital is part of the authorized capital, while Capital Reserve is created from profits.
2. Sweat Equity Shares
3. Employee Stock Option Plan
4. Right Issue

5. 90% of the issued capital
6. A selected group of investors
7. Shareholders as free shares out of reserves
8. Equity Shares
9. Equity Shares
10. Existing shareholders

Self-Assessment Questions

- ◊ Distinguish between stocks and shares
- ◊ Equity shares represent real ownership in the company. Elucidate.
- ◊ How is DVR different from ordinary equity shares?
- ◊ How are preference shares different from equity shares?
- ◊ What is meant by a prior claim on profits and assets?
- ◊ Does convertibility add attraction to preference shares?
- ◊ Distinguish between cumulative and non-cumulative preference shares.
- ◊ Private placement of shares is preferential allotment of equity shares. Comment.
- ◊ How does QIP differ from IPP?
- ◊ What is IPO? Is it limited only to the issue of a private limited company that converts to a public limited company?
- ◊ What is meant by FPO?
- ◊ Write a short note on ESOP. Why is it provided by companies?
- ◊ What is sweat equity?
- ◊ What do you mean by the pre-emptive right of shareholders?
- ◊ Rights issue preserves the holding proportion of existing shareholders. Elucidate.

Assignments

1. X, Y, Ltd. was registered with an authorized capital of 2, 00, 000 shares of ₹10 each. 1, 40, 000 shares were issued to the public. The public subscribed for 1, 00, 000 shares. The company called up ₹7 per share. All the money called up was duly received. Show the amounts of various types of share capital.

   [Authorised capital ₹20,00,000; Issued capital ₹14,00,000; Subscribed capital ₹10,00,000; Called up capital ₹7, 00, 000]
2. Discuss the role of the Employees Stock Option Plan (ESOP) and Sweat Equity Shares in employee motivation and company growth.
3. Explain the different phases of capital in a company and their significance in financial management.
4. Differentiate between Reserve Capital and Capital Reserve with suitable examples. Why is it important for companies to maintain these reserves?
5. Compare and contrast equity shares and redeemable preference shares in terms of rights, returns, and redemption
6. Elaborate the concept of Bonus Issue, and how does it impact the company's financial structure? How does it differ from a Rights Issue?

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Unit 2 Issue of Shares and Forfeiture and Reissue of Shares

Learning Outcomes

After completing this unit, the learner will be able to:

- ◊ familiarise with the Issue of shares at par and premium
- ◊ learn about the Treatment of Fraction shares
- ◊ get an idea aboutCalls in arrears and calls in advances
- ◊ grasp the concept of Pro-rata allotment
- ◊ able to do the accounting treatments of forfeiture of shares
- ◊ comprehension of the reissue of shares and accounting treatments

Prerequisite

A small company named GreenLeaf Foods Ltd., started by two friends who dream of expanding their organic products across India. To raise the money needed, they decide to issue shares to the public, inviting people to invest and become part-owners of the company. Many investors happily apply and pay for the shares, helping GreenLeaf grow. However, not everyone keeps up with their payments—some shareholders fail to pay the remaining instalments. To protect the company, their shares are forfeited, meaning the company cancels their ownership and keeps the amount already paid. Later, when GreenLeaf needs more funds, these forfeited shares are reissued to new interested investors at a fair price, helping the company recover its financial strength. Through this journey, learners understand how companies issue shares, what happens when shareholders default, and how reissued shares maintain the company's capital flow.

Keywords

Shares at par and premium, Fraction shares, Pro-rata allotment, forfeiture and reissue of shares

Discussion

1.2.1 Introduction

A salient characteristic of the capital of a company is that the amount on its shares can be gradually collected in easy instalments spread over some time depending upon its growing financial requirement. The first instalment is collected along with the application and is thus, known as application money, the second on allotment (termed as allotment money), and the remaining instalments are termed as first call, second call, and so on. The word final is suffixed to the last instalment. However, this in no way prevents a company from calling the full amount on shares right at the time of application.

1.2.1.1 Offer Document

Companies raising capital from the primary market by way of an initial public offer (IPO) or follow-on public offer (FPO) need to comply with the stipulations of the Companies Act 2013 and amendments made from time to time that are applicable. A company needs to issue an 'Offer document' which contains all the relevant information about the company, promoters, projects, financial details, objects of raising the money, terms of the issue, etc., and is used for inviting subscriptions to the issue being made by the issuer. An 'Offer Document' is called a "Prospectus" in case of a public issue and a "Letter of Offer" in case of a rights issue. Though various types of prospectuses exist technically, in practical terms they call for applications from the public in terms of the number of shares they are interested in buying.

This document called prospectus is registered with the Registrar of Companies (RoC) before the issue opens in case of a fixed price issue and after the closure of the issue in case of a book-built issue. The details of the class of shares and several shares now available for subscription, the price payable or that can be bid from the price band specified, and how much amount has to be paid, whether in instalments or as a one-time payment, etc. will be informed through the prospectus.

1.2.1.2 Pricing of Issues

SEBI does not play any role in price fixation, even after the abolishment of the office of the erstwhile regulator called "Controller of Capital Issues.' The issuer or issuing company decides the price in consultation with the merchant banker based on market demand. The offer document should have full disclosures of the parameters such as earnings per share (EPS), price-earnings (PE) multiple, return on net worth, etc. which are taken into account by the Merchant Banker and the issuer for deciding the price. An issue can be classified into a Fixed Price issue or book-built issue, based on Pricing,

1.2.1.3 Fixed Price Issue

A "Fixed price issue" is an issue where the issuer decides the issue price at the outset and mentions it in the Offer Document. Under such an issue, the company going public determines a fixed price at which its shares are offered to investors. The investors know the share price before the company collects such capital from the primary market. The company knows the demand for the shares from the markets is only when the issue is closed.

1.2.1.4 Book built Issue

Book building refers to the process by which the issuer through a merchant banker attempts to determine the price at which shares can be offered. It is the method of price discovery where investor demand for shares is generated and recorded before arriving at an issue price.

"Book Built issue" refers to an issue where the price of an issue, disclosed in the red herring prospectus as a floor price or price band, is discovered based on demand received from the prospective investors at various price levels.

1.2.1.5 Price band

In the process of price discovery, known as book building, a floor and ceiling price limit or price band within which the bids can move is disclosed. The price band is an auction pricing technique where the issuer indicates an upper and lower price limit, within which buyers place bids as the desired price at which he/ she would like to buy. Thus, the price band is a range of prices within which investors can bid. The spread between the floor and the ceiling of the price band shall not be more than 20%.

1.2.1.6 "Cut-off" option

The actual discovered issue price can be any price in the price band or any price above the floor price and hence the issue price is coined as the "Cut off price". The cut-off option is an option available for retail individual investors who apply for securities worth up to Rs 2, 00, 000/- only. Small retail investors can opt for this cut-off while bidding to indicate their willingness to subscribe to shares at any price discovered within the price band. The cut-off bids always remain valid for allotment even if the price bid by the applicant is less than the discovered price.

If a specific price, without a cut-off option, bid by the applicant is lower than the price discovered, he will not get an allotment of shares. For example, if the price band is Rs. 200 to Rs 210 and if the applicant bids a price of say, Rs. 204 it means that he is willing to buy shares at any discovered price of Rs. 204 or less. If the issuer/ merchant banker discovers a price of Rs. 207 based on demand, then the applicant who has bid Rs. 204 will not get allotment. However, if the applicant has marked the cut-off option while bidding instead of at Rs. 204, he will still be eligible for allotment even if the discovered price is Rs. 207.

1.2.1.7 Minimum Subscription

Minimum subscription refers to the minimum amount that a company should raise at the time of issuing capital. The requirement for minimum subscription applies to all companies which raise funds from the public. The contexts under which new companies and existing companies are brought under the purview of statutory requirements of minimum subscription need to be explored as follows.

In the case of newly registered companies, a minimum capital has to be raised from the first issue of shares to cover the capital expenditure necessary such as the purchase of property and fixed assets, preliminary expenses in the form of underwriting commission, and brokerage on the issue, working capital and any form of repayment of debts borrowed to meet the above. The board of directors may fix such minimum subscription to be collected on the issue of shares to comply with the requirement of obtaining a certificate of commencement of business. This provision in the Companies Act ensures that only companies with sufficient capital are permitted to commence business.

Yet another statutory requirement of minimum subscription is stipulated by the Securities and Exchange Board of India (SEBI). This applies to all the public and rights issues. SEBI stipulates that if 90% of the issue, including the devolvement of underwriters and guarantors, is not subscribed for by the public then the whole issue becomes void and the application money or whatever is collected from the applicant should be refunded.

1.2.2 Issue of Shares

A salient characteristic of the capital of a company is that the amount on its shares can be gradually collected in easy instalments spread over some time depending upon its growing financial requirement. The first instalment is collected along with the application and is thus, known as application money, the second on allotment (termed as allotment money), and the remaining installments are termed as first call, second call, and so on. The word final is suffixed to the last instalment. However, this in no way prevents a company from calling the full amount on shares right at the time of application.

The important steps in the procedure of sharing issues are:

- ◊ **Issue of Prospectus :** The company first issues the prospectus to the public. The prospectus is an invitation to the public that a new company has come into existence and needs funds for doing business. It contains complete information about the company and how the money is to be collected from the prospective investors.

- ◊ **Receipt of Applications :** When a prospectus is issued to the public, prospective investors intending to subscribe to the share capital of the company would make an application along with the application money and deposit the same with a scheduled bank as specified in the prospectus. The company has to get a minimum subscription within 120 days from the date of the issue of the prospectus. If the company fails to receive the same within the said period, the company cannot proceed for the allotment of shares and application money should be returned within 130 days of the date of issue of prospectus.
- ◊ **Allotment of Shares :** If a minimum subscription has been received, the company may proceed with the allotment of shares after fulfilling certain other legal formalities. Letters of allotment are sent to those to whom the shares have been allotted, and letters of regret to those to whom no allotment has been made. When allotment is made, it results in a valid contract between the company and the applicants who now become the shareholders of the company.

Shares of a company are issued either at par or at a premium. Shares are to be issued at par when their issue price is exactly equal to their nominal value according to the terms and conditions of the issue. When the shares of a company are issued more than its nominal value (face value), the excess amount is called the premium.

Irrespective of the fact that shares are issued at par or at a premium, the share capital of a company as stated earlier, may be collected in installments payable at different stages.

1.2.3 Accounting Treatment

On application : The amount of money paid in various installments represents the contribution to share capital and should ultimately be credited to share capital. However, for the sake of convenience, initially, individual accounts are opened for each instalment. All money received along with the application is deposited with a scheduled bank in a separate account opened for the purpose. The journal entry is as follows:

Bank A/c Dr.

To Share Application A/c (Amount received on application for — shares @ Rs. ______ per share)

On allotment: When a minimum subscription has been received and certain legal formalities on the allotment of shares have been duly complied with, the directors of the company proceed to make the allotment of shares.

The allotment of shares implies a contract between the company and the applicants who now become the allottees and assume the status of shareholders or members.

The journal entries about the allotment of shares are as follows:

1. For Transfer of Application Money

Share Application A/c Dr.

To Share Capital A/c

(Application money on _____ Shares allotted/ transferred to Share Capital)

2. For Money Refunded on Rejected Application

Share Application A/c Dr.

To Bank A/c (Application money returned on rejected application for ___shares)

3. For Amount Due on Allotment

Share Allotment A/c Dr.

To Share Capital A/c

4. For Adjustment of Excess Application Money

Share Application A/c Dr.

To Share Allotment A/c (Application Money on __Shares @ Rs__per shares adjusted to the amount due on allotment).

5. For Receipt of Allotment Money

Bank A/c Dr.

To Share Allotment A/c (Allotment money received on ___Shares @ Rs. — per share Combined Account)

Note: - The journal entries (2) and (4) can also be combined as follows: Share Application A/c To Share Allotment A/c To Bank A/c (Excess application money adjusted to share allotment and balance refunded)

On Calls: Calls play a vital role in making shares fully paid up and in realizing the full amount of shares from the shareholders. In the event of shares not being fully called up till the completion of allotment, the directors have the authority to ask for the remaining amount on shares as and when they decide about the same. It is also possible that the timing of the payment of calls by the shareholders is determined at the time of the share issue itself and given in the prospectus.

Two points are important regarding the calls on shares. First, the amount on any call should not exceed 25% of the face value of shares. Second, there must be an interval of at least one month between the making of two calls unless otherwise provided by the articles of association of the company.

When a call is made and the amount of the same is received, the journal entries are as given below:

1. For Call Amount Due

Share Call A/c Dr.

To Share Capital A/c (Call money due on ___Shares @ Rs. ____ per share)

2. For Receipt of Call Amount

Bank A/c Dr.

To Share Call A/c (Call money received)

word/words First, Second, or Third must be added between the words "Share" and 'Call' in the Share Call account depending upon the identity of the call made. For example, in the case of the first call, it will be termed as 'Share First Call Account', in the case of the second call it will be 'Share Second Call Account', and so on. Another point to be noted is that the words 'and Final' will also be added to the last call, say, if the second call is the last call it will be termed as 'Second and Final Call' and if it is the third call which is the last call, it will be termed as 'Third and Final Call'. It is also possible that the whole balance after allotment may be collected in one call only. In that case, the first call itself shall be termed as the 'First and Final Call'.

1.2.3.1 Acceptance of Application Deposit

The application deposit payable on security should be more than five percent of the nominal value. Also, the company should not collect the application deposit in cash. The company may receive cheques or demand drafts for the payment of the application deposit. In such cases, the company should ensure that the cheques or demand drafts received are not post-dated instruments.

The funds collected by the company through an application deposit should be maintained in a separate bank account. The funds should be used only for the purposes mentioned in the prospectus. A company is not allowed to make use of capital funds towards the settlement of short-term credit obligations or revenue expenditures. The company may have working capital needs that require immediate disbursement of funds. In such cases, the company should ensure that capital funds are not deployed towards the disbursement. Thus, funds deposited by the investors should only be used to purchase separately distinguishable assets.

The application deposit may be less than the face value of the capital issued. In such cases, the ceiling limit of ninety percent should be applied to the number of applications sold. Cheques submitted to the company for paying the application deposit may not be successfully cleared. In such cases, the ceiling limit should be calculated after excluding the value of cheques which are not cleared. The ceiling limit should be applied after the defaulting subscribers have been excluded. A defaulting subscriber is a person who has paid the application deposit but has not made any subsequent contribution toward the capital.

The company may make a statement concerning minimum subscription in the prospectus. The statement may indicate a lower ceiling limit than ninety percent. In such cases, the statement will not be valid. Hence, the ceiling limit of ninety percent will continue to apply to the company. Alternatively, the company may indicate a ceiling limit that is higher than ninety percent. In such cases, the company is bound by the higher ceiling.

1.2.3.2 Refund of Application Deposit

- A company can commence allotment of securities only after the targeted minimum subscription is fulfilled. There may be a failure on the part of the company to reach the targeted minimum subscription. In such circumstances, the liability to make a refund will arise for the company. The Act requires that in case of a failure to reach the minimum subscription, the application deposit should be refunded to the extent of one hundred percent. In case the company fails to refund the application deposit, the affected person may file a suit against the company. The maximum time limit for filing a lawsuit is three years.
- The time limit allowed for the collection of the minimum subscription is one hundred and twenty days. The period should be calculated from the date of opening of the issue. Also, the minimum subscription should be collected within thirty days from the date of issue of the prospectus. The time limits mentioned are applicable only for receipt of the minimum subscription. Hence, allotment of securities can be made even after completion of the time limit.
- In case the minimum subscription is not reached, the application deposit should be refunded. The refund should be made within fifteen days from the date of closure of the issue. In case there is a delay beyond fifteen days, the applicants should be repaid with interest at the rate of fifteen percent per annum. The directors of the company should also bear the liability to meet the interest obligation. The refund should be made directly to the bank account of the applicant.
- In case there is any default in complying with the above provisions, the company and the defaulting officers should pay a fine of one thousand rupees per day. The penalty will be calculated for the number of days for which the company has committed the default. However, the maximum amount of fine payable cannot exceed one lakh rupees.

1.2.4 Issue of Shares for Consideration

Shares are one of the most important instruments to raise capital at all stages of business. The issue of shares seems to be a simple process and most of the people know about it in its general form only. But the picture is not as it seems to be. There are various means and purposes for issuing shares. There are many purposes for which they're issued. In this article, we will understand the concept of the issue of shares for consideration (other than cash).

Means of Issue of Shares

There are 2 generally two means of the issue of shares:

i. For Cash

ii. For Consideration Other than Cash

1.2.4.1 Issue of Shares for Cash

In the case of the issue of shares for cash, the company provides the shares to the investor in exchange for cash as consideration. It is the most general means of the issue of shares. Such kind of issuing is done for the general public. The Company calls such total cash consideration in certain parts or installments

1.2.4.2 Issue of shares for consideration other than cash

When an asset is acquired by a company, the payment of the asset price can be made by the issue of shares or in cash to the vendor. Moreover, when shares are given against the purchase price, it is known as the 'Issue of shares for consideration other than cash'. In this case, shares are not open to the general public.

As the term clears itself, the issue of shares for consideration other than cash means shares of the company are issued to somebody for anything that is not cash.

1. In case of Purchase of Assets

Shares issued for consideration other than cash, to purchase Asset:

Sundry Assets A/c	Dr.
To Share CapitalA/c	

2. In Case of the Purchase of a Business

When a company purchases the business of another company, it takes over the assets as well as the liabilities of the company at a predetermined price. Moreover, the difference in the prices of the assets and liabilities which is taken over is called 'Net Assets'. Net asset may be tranferred to capital reserve account or Good will a/c based on conditions.

Condition 1- When assets taken over is less than the liabilities, the difference is transfer to Goodwill account.

Sundry assets	Dr.
Goodwill a/c	Dr.
To sundry liabilities a/c	
To Share capital a/c	

Condition 2- when the assets taken over is greater than liabilities, the difference in net assets is transfer to capital reserve account.

Sundry assets Dr.

To sundry liabilities a/c

To Share capital a/c

To capital reserve a/c

1.2.5 Calls in Arrears

It may happen that shareholders do not pay the call amount on the due date. When any shareholder fails to pay the amount due on allotment or on any of the calls, such amount is known as 'Calls in Arrears'/'Unpaid Calls'. Calls in Arrears represent the debit balance of all the call accounts. Such amount shall appear as a 'Note to Accounts (Refer to Chapter 3). However, where a company maintains a 'Calls in Arrears' Account, it needs to pass the following additional journal entry:

Calls in Arrears A/c Dr.

To Share First Call Account A/c

To Share Second and Final Call Account A/c (Calls in arrears brought into account)

The Articles of Association of a company may empower the directors to charge interest at a stipulated rate on calls in arrears. If the articles are silent in this regard, the rule contained in Table F shall be applicable which states that the interest at a rate not exceeding 10% p.a. shall have to be paid on all unpaid amounts on shares for the period intervening between the day fixed for payment and the time of actual payment thereof.

On receipt of the call amount together with interest, the amount of interest shall be credited to the interest account while call money shall be credited to the respective call account or to calls in arrears account. When the shareholder makes the payment of calls in arrears together with interest, the entry will be as follows:

Bank A/c Dr.

To Calls in Arrears A/c

To Interest on Calls in Arrears A/c (Calls in arrears received with interest)

Note: If nothing is specified, there is no need to take the interest on calls in arrears account and record the above entry

1.2.6 Calls in Advance

Sometimes shareholders pay a part or the whole of the amount of the calls not yet made. The amount so received from the shareholders is known as "Calls in Advance".

The amount received in advance is a liability of the company and should be credited to the 'Call in Advance Account." The amount received will be adjusted towards the payment of calls as and when they become due. Table F of the Companies Act provides for the payment of interest on calls in advance at a rate not exceeding 12% per annum.

The following journal entry is recorded for the amount of calls received in advance.

Bank A/c Dr.

To Calls in Advance A/c (Amount received on call in advance)

On the due date of the calls, the amount of 'Calls in Advance' is adjusted by the following entry:

Calls in Advance A/c Dr.

To Particular Call A/c (Calls in advance adjusted with the call money due)

The balance in the 'Calls in Advance' account is shown as a separate item under the title Equity and Liabilities in the company's balance sheet under the head 'current liabilities', as sub-head 'others current liabilities. It is not added to the amount of paid-up capital.

As 'Calls in Advance' is a liability of the company, it is under obligation, if provided by the Articles, to pay interest on such amount from the date of its receipt up to the date when an appropriate call is due for payment. A stipulation is generally made in the Articles regarding the rate at which interest is payable. However, if Articles are silent on this account, Table F is applicable which provides for interest on calls in advance at a rate not exceeding 12% per annum.

1.2.7 Over Subscription

There are instances when applications for more shares of a company are received than the number offered to the public for subscription. This usually happens in respect of shares issued by well-managed and financially strong companies and is said to be a case of 'Over Subscription'.

In such a condition, three alternatives are available to the directors to deal with the situation:

1. they can accept some applications in full and reject others;
2. they can make a pro-rata allotment to all; and
3. they can adopt a combination of the above two alternatives which happens to be the most common course adopted in practice.

The problem of over-subscription is resolved with the allotment of shares. Therefore, from the accounting point of view, it is better to place the situation of over-subscription within the total frame of application and allotment, i.e., receipt of application amount, amount due on the allotment, and its receipt from the shareholders, and the same has been observed in the pattern of entries.

First Alternative: When the directors decide to fully accept some applications and reject others, the application money received on rejected applications is fully refunded. For example, a company invited applications for 20, 000 shares and received applications for 25, 000 shares. The directors rejected the applications for 5, 000 shares which are more than the required number and refunded their application money in full. In this case, the journal entries on application and allotment will be as follows:

The journal entries on application and allotment according to this alternative are as follows:

1. Bank A/c Dr.
   To Share Application A/c
   (Money received on application for 25, 000 shares @ Rs. _ per share)

2. Share Application A/c Dr.
   To Share Capital A/c
   To Bank A/c

(Transfer of application for money 20, 000 for shares allotted and money refunded on applications for 5, 000 shares rejected)

3. Share Allotment A/c Dr.
   To Share Capital A/c
   (Amount due on the allotment of 20, 000 shares @ Rs. _ per share)

4. Bank A/c Dr.
   To Share Allotment A/c
   (Allotment money received)

Second Alternative: When the directors opt to make a proportionate allotment to all applicants (called 'pro-rata' allotment), the excess application money received is normally adjusted towards the amount due on allotment. In case, the excess application money received is more than the amount due on allotment of shares, such excess amount may either be refunded or credited to calls in advance.

For example, in the event of applications for 20, 000 shares being invited and those received are for 25, 000 shares, it is decided to allot shares in the ratio of 4:5 to all applicants. It is a case of pro-rata allotment and the excess application money received on 5, 000 shares would be adjusted towards the amount due on the allotment of 20, 000 shares. In this case, the journal entries on application and allotment will be as follows

1 Bank A/c Dr.

To Share Application A/c

(Application money received on 25, 000 shares @ Rs. _ per Share)

2 Share Application A/c Dr

To Share Capital A/c

To Share Allotment A/c

(Transfer of application money to share capital and the excess application money on 5, 000 shares credited to share allotment account)

3 Share Allotment A/c Dr.

To Share Capital A/c

(Amount due on allotment of 25, 000 shares @ Rs. _ per share)

4 Bank A/c Dr.

To Share Allotment A/c

(Allotment money received after adjusting the amount already received as excess application money)

Third Alternative: When the application for some shares is rejected outrightly; and pro-rata allotment is made to the remaining applicants, the money on rejected applications is refunded and the excess application money received from applicants to whom pro-rata allotment has been made is adjusted towards the amount due on the allotment of shares allotted.

For example, a company invited applications for 10, 000 shares and received applications for 15, 000 shares. The directors decided to reject the applications for 2, 500 shares outright and to make a pro-rata allotment of 10, 000 shares to the applicants for the remaining 12, 500 shares so that four shares are allotted for every five shares applied. In this case, the money on applications for 2, 500 shares rejected would be refunded fully, and that on the remaining 2, 500 shares (12, 500 shares – 10, 000 shares) would be adjusted against the allotment amount due on 10, 000 shares allotted and credited to the share allotment account, the journal entries on application and allotment recorded as follows:

1. Bank A/c Dr.

To Share Application A/c

(Money received on application for 15, 000 shares @ Rs. _ per share)

2. Share Application A/c Dr.

To Share Capital A/c

To Share Allotment A/c

To Bank A/c

(Transfer of application money to share capital, and the excess application amount of pro-rata allottees credited to share allotment and the amount on rejected applications refunded)

3. Share Allotment A/c Dr.

To Share Capital A/c

(Amount due on the Allotment of 10, 000 shares @ Rs. _ per share)

4. Bank A/c Dr.

To Share Allotment A/c (Allotment money received after adjusting the amount already received as excess application money

1.2.8 Under Subscription

Under subscription is a situation where number of shares applied for is less than the number for which applications have been invited for subscription. For example, a company offered 2 lakh shares for subscription to the public but the applications were received for 1, 90, 000 shares, only. In such a situation, the allotment will be confirmed to 1, 90, 000 shares and entries shall be made accordingly. However, as stated earlier, it must be ensured that the company has received the minimum subscriptions and the company will have to refund the entire subscription amount received.

1.2.8.1 Issue of Shares at a Premium

It is quite common for the shares of financially strong and well-managed companies to be issued at a premium, i.e. at an amount more than the nominal or par value of shares. Thus, when a share of the nominal value of Rs. 100 is issued at Rs. 105, it is said to have been issued at a premium of 5 percent.

When the issue of shares is at a premium, the amount of premium may technically be called at any stage of the issue of shares. However, the premium is generally called with the amount due on allotment, sometimes with the application money and rarely with the call money. The premium amount is credited to a separate account called 'Securities Premium Account' and is shown under the title 'Equity and Liabilities' of the company's balance sheet under the head 'Reserves and Surpluses'. It can be used only for the following five purposes:

a. to issue fully paid bonus shares to the extent not exceeding the unissued share capital of the company;
b. to write off the preliminary expenses of the company;
c. to write off the expenses of, or commission paid, or discount allowed on any securities of the company; and
d. to pay a premium on the redemption of preference shares or debentures of the company.
e. Purchase of its shares (i.e., buyback of shares)

The journal entries for shares issued at a premium are as follows:

1. For Premium Amount called with Application money

a. Bank A/c Dr.

To Share Application A/c

(Money received on application for — shares @ Rs. — per share including premium)

b. Share Application A/c Dr.

To Share Capital A/c

To Securities Premium Reserve A/c

(Transfer of application money to share capital and securities premium account)

2. Premium Amount called with Allotment Money

a.. Share Allotment A/c Dr.

To Share Capital A/c

To Securities Premium Reserve A/c

(Amount due on allotment of shares @ Rs — per share including premium)

b. Bank A/c Dr.

To Share Allotment A/c

(Allotment money received including premium)

3. Premium Amount called with Call Money

a. Share Application A/c

To Share Capital Reserve A/c

To Securities Premium A/c

(Amount due on 1st/2nd call @Rs— per share including premium)

b. Bank A/c Dr.

To Share Call A/c

(Call money received including premium)

Illustration 1

Jupiter Company Limited issued 35, 000 equity shares of Rs. 10 each at a premium of Rs.2 payable as follows:

On Application Rs. 3

On Allotment Rs. 5 (including premium)

Balance on First and Final Call

The issue was fully subscribed. All the money was duly received. Record journal entries in the books of the Company

Solution:

Books of Jupiter Company Limited Journal

Date	Particulars	L.F	Debit Amount	Credit Amount
	Bank A/c Dr.		105000	
	To Equity Share Application A/c			105000
	(Money received on applications for 35, 000 shares @ Rs. 3 per share)			
	Equity Share Application A/c Dr.		105000	
	To Equity Share Capital A/c			105000
	(Transfer of application money on allotment to share capital)			
	Equity Share Allotment A/c Dr.		175000	
	To Equity Share Capital A/c			105000
	To Securities Premium Reserve A/c			70000
	(Amount due on allotment of 35, 000 shares @ Rs. 5 per share including premium			
	Bank A/c Dr.		175000	
	To Equity Share Allotment A/c			175000
	(Money received including premium)			
	Equity Share First and Final Call A/c Dr.		140000	
	To Equity Share Capital A/c			140000
	(Amount due on First and Final Call of Rs. 4 per share on 35, 000 shares)			
	Bank A/c Dr.		140000	
	To Equity Share First and Final Call A/c			140000
	(Money received on First and Final Call)			

1.2.9 Forfeiture of Shares

When shareholders fail to pay calls, the company, if empowered by its articles, may forfeit the share. The Company's Act does not contain any specific provisions regarding forfeiture of shares. The power to forfeit shares must be provided in the Articles of Association of the company. If a shareholder has not paid any call on the day fixed for payment thereof and fails to pay it even after his attention is drawn to it by the secretary by registered notice, the Board of Directors passes a resolution to the effect that such shares be forfeited. Shares once forfeited become the property of the company and may be sold on such terms as directors think fit.

Forfeiture of shares brings about compulsory termination of membership and the company takes away the shares from members by way of plenty for non-payment of allotment and/or call money.

The effect of forfeiture of shares is that the defaulting shareholder loses all his rights in shares and ceases to be a member. The name of the shareholder is removed from the Register of Members and the amount already paid by him/her is forfeited. He loses all privileges and rights of membership.

1.2.9.1 Journal Entries

Following Journal Entry is passed at the time of forfeiture of shares.

Share Capital Account Dr. (with the called amount on such shares as capital)

Security Premium Account Dr. (if not received)

To Unpaid Calls Account (with an amount which became due but not paid)

To Shares Forfeited Account (with the amount already received on such shares)

On forfeiture, the Share Capital Account has been debited as it reduces the share capital, and calls due but not received will be credited to cancel their debit balance standing in the books. The premium received on the original issue of shares cannot be cancelled. Securities Premium not received on the issue of shares will be cancelled by debiting the securities Premium Account with the forfeiture entry. The balance of shares capital will be maintained until all forfeited shares are reissued.

Illustration 2

A limited company has an authorised capital of ₹2, 50, 000 in ₹10 shares. Of these 4000 shares were issued as fully paid in payment of the building purchased and the public subscribed for 8, 000 shares, and during the first year ₹5 per share was called payable ₹2 on application, ₹1 on the allotment, ₹1 on the first call and ₹1 on the second call. The amounts received in respect of these shares were as follows:

On 6, 000 shares the full amount called on 500 shares ₹3 per share.

On 1, 250 shares ₹4 per shareand on 250 shares ₹2 per share

The director forfeited the shares on which less than ₹4 had been paid.Show Journal Entries in the books of the company.

Solution

Building Account	Dr.	40, 000	
To Share Capital Account			40,000
(Being issue of 4, 000 fully paid shares of ₹10 each for the purchase of the building)			
Bank Account	Dr.	16, 000	

To Share Application Account			16,000
(Being application money received on 8, @₹2 per share000 shares)			
Share Application Account	Dr.	16, 000	
To Share Capital A/c			16,000
(Being Application money received)			
Share Allotment A/c	Dr.	8, 000	
To Share Capital A/c			8, 000
(Being allotment money due on 8, 000 shares @₹1per share)			
Bank A/c	Dr.	7, 750	
To Share Allotment A/c			7, 750
(Being Allotment money received)			
Share First Call Account	Dr.	8, 000	
To Share Capital A/c			8, 000
(Being the amount due on the first call on 8, 000 shares @ ₹1 per share)			
Bank A/c	Dr.	7, 250	
To Share First Call Account			7, 250
(Being amount received on account of first call on 7, 250 shares of ₹1 per share)			
Share Second Call Account	Dr.	8, 000	
To Share Capital Account			8, 000
(Being the amount due on the second call on 8, 000 shares ₹1 per share)			
Bank A/c	Dr.	6, 000	
To Share the Second Call Account			6, 000
(Being amount received on account of the second call on 6, 000 shares @ ₹1 per share)			
Share Capital Account	Dr.	3, 750	
To Share Allotment			250
To Share First Call Account			750
To Share Second Call Account			750
To Share For feiture Account			2,000

(Being for feiture of 750 shares on which less than ₹4 had been paid)

1.2.10 Reissue of All Forfeited Shares

Forfeited shares may be reissued by the company directors for any amount but if such shares are issued at a discount, then the amount of discount should not exceed the actual amount received on forfeited shares plus the original discount on reissued shares, If any. The purchaser of forfeited reissued shares is liable for payment of all future calls duly made by the Company.

The following journal entry on such reissue is passed:

Bank A/c Dr. (Amount received on such reissue)

Shares Forfeited A/c Dr. (loss on the reissue of shares called capital loss)

To Share Capital A/c (with face value of shares)

To Securities Premium A/c (If shares are reissued at a premium)

Illustration 2

A Company invited the public to subscribe to 1,00,000 Equity Shares of ₹10 each at a premium of ₹1 per share payable on the allotment. The payment was to be made as follows:

On application ₹ 3; on allotment ₹ 3; on first call ₹ 3 and on final call ₹ 2.

Applications were received for 1, 30, 000 shares; applications for 20, 000 shares were rejected and allotment was made proportionately to the remaining applicants. Both the calls were made and all the moneys were received except the final call on 3, 000 shares were forfeited after due notice. Later all these shares were issued as fully paid at ₹8.50 per share. Pass journal entries.

Solution

Bank A/c Dr.		3,90,000	
To Equity Share Application A/c			3,90,000
(Application money received for 1, 30, 000 shares @₹3 per share)			
Equity Share Application A/c Dr.		3,90,000	
To Equity Share Capital A/c			3,00,000
To Bank A/c			60,000
To Share Allotment A/c			30,000
(Application money of 1, 00, 000 shares transferred to share capital A/c and the balance returned to applicants and used for share allotment A/c)			
Equity Share Allotment A/c Dr.		3,00,000	
To Equity Share Capital A/c			2,00,000
To Securities Premium A/c			1,00,000
(Allotment money due on 1, 00, 000 shares)			
Bank A/c Dr.		2,70,000	
To Equity Share Allotment			2,70,000
(Receipt of the amount due on allotment)			
Equity Share First Call A/c Dr.		3,00,000	
To Equity Share Capital A/c			3,00,000

(Being receipt of the amount due on the first call)			
Bank A/c Dr.		3,00,000	
To First Call A/c			3,00,000
Equity Share Second & Final Call A/c Dr.		2,00,000	
To Equity Share Capital A/c			2,00,000
(Amount due on second and final call)			
Bank A/c Dr.		1,94,000	
To Equity Share Second and Final Call A/c			1,94, 000
(Receipt of the amount due on the second and final call except on 3, 000 shares)			
Equity Share Capital A/c Dr		30,000	
To Equity Share Second & Final Call A/c			6,000
To Shares Forfeiture A/c			24,000
(Being receipt of the amount due on the second & final call except on 3, 000 shares)			
Bank A/c Dr.		25,500	
Share Forfeited A/c Dr.		4,500	
To Equity Share Capital A/c			30,000
(Reissue of 3, 000 shares @₹8.50 per share)			
Shares Forfeited A/c Dr.		19,500	
To Capital Reserve A/c			19,500
(Balance of shares forfeited A/c being capital profit transferred to Capital Reserve A/c)			

1.2.11 Surrender of Shares

After the allotment of shares, sometimes a shareholder is not able to pay further calls and returns his shares to the company for cancellation. Such voluntary return of shares to the company by the shareholder himself is called surrender of shares. Surrender of shares has no separate accounting treatment but it will be like that of forfeiture of shares. The same entries (as are passed in case of forfeiture of shares) will be passed in case of surrender of shares.

1.2.11.1 Distinction between Surrender of Shares and Forfeiture of Shares

No.	Surrender of Shares	Forfeiture of Share
1	It is at the initiative of the shareholders concerned	It is the initiative of the company.
2	In this case, the procedure for the reduction of share capital as provided in section 100 of the Companies Act should be followed.	No such procedure is followed for the forfeiture of shares.

3	The shareholder is stopped from questioning the validity of the surrender of shares.	The shareholder can challenge the defects in the notice for forfeiture of shares in case of forfeiture of shares.
4	The company is saved from the formalities of serving notice and waiting till the period of notice is over.	The forfeiture is possible only when the Articles of Association of a company empowers the Board of Directors to do so

Recap

- ◊ Issue at Par: Shares are issued at their face value (e.g., ₹10 share issued at ₹10).
- ◊ Issue at Premium: Shares are issued above face value (e.g., ₹10 share issued at ₹15, with ₹5 premium recorded in the Securities Premium Reserve).
- ◊ Calls in Arrears: When shareholders fail to pay due amounts on their shares. The company may charge interest.
- ◊ Calls in Advance: When shareholders pay in excess of the required call amount before demand. Interest may be given.
- ◊ Pro -rata allotment - • Happens when share applications exceed available shares.Shares are allotted proportionally (e.g., If a company receives applications for 1, 00, 000 shares but only issues 50, 000, allotment is in a 1:2 ratio).
- ◊ Forfeiture of share - When a shareholder fails to pay call money, the company forfeits (cancels) their shares.The amount paid is not refunded, and the shares can be reissued later.
- ◊ Reissue of share -Forfeited shares are reissued at par, premium, or discount. The discount cannot exceed the forfeited amount. Reissue Example: If a share forfeited at ₹8 is reissued at ₹6, the loss of ₹2 is adjusted from the Forfeited Shares Account.

Objective questions

1. Which Indian Accounting Standard deals with Property, Plant and Equipments?
2. What is fair value?
3. How is inventory valued as per Ind AS 2?
4. What is the term that is used to denote an identifiable non-monetary asset without physical substance?
5. State the fulform of PP&E.
6. What are the costs linked to the unit of production and indirect costs incurred in converting raw materials into finished products known as?
7. Which Ind AS deals with intangible assets?
8. List out the two models for the measurement of the intangible assets after recognition.

Answers

1. True
2. False
3. Nominal Account
4. 5% of the face value of shares
5. First offered to the existing shareholders
6. Deferred Shares
7. Reserve capital
8. 12%
9. Issue of bonus shares
10. 10%
11. Owners of the company(In partial sense only)
12. Under subscription
13. Over Subscription’
14. Calls in Arrears or Unpaid Calls

Self Assessment Questions

1. What are the different types of shares?
2. Short note on Pre-rata allotment?
3. Explain the journal entries for re-issue of shares?
4. Explain the accounting treatement for forfuture of share?
5. Security premium on issue of shares can be used for what purposes?

Assignments

1. A company was formed with a capital of ₹15, 00, 000 in shares of ₹10 each. It offered to the public 1, 00, 000 shares payable ₹1 per share on application, ₹2 per share on the allotment, and ₹3 per share on the first call. The balance of ₹4 per share is to be called only in case of necessity. Applications were received for 90, 000 shares and the shares were accordingly allotted. All the money was duly received except allotment money on 200 shares and the first call on 500 shares.

   Journalise the transactions and prepare the Balance sheet.

   [Calls in Arrears ₹1, 900; B/S total ₹5, 38, 100]
2. A company issues 10, 000 equity shares at ₹10 each, with a premium of ₹5 per share. Explain the journal entries for this transaction. What are the advantages and disadvantages of issuing shares at a premium?

   (Security premium – 10000*5 = 50000)
3. Why do companies forfeit shares? What are the accounting treatments for forfeiture? If a company forfeits 5, 000 shares due to non-payment of call money and later reissues them at a discount, how would the company record this transaction?
4. "Reissued forfeited shares often benefit the company." Do you agree or disagree? Support your answer with accounting entries and real-world examples.

Suggested Reading

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BLOCK

ACCOUNTING FOR DEBENTURES

Unit 1

Introduction to Debentures

Learning Outcomes

After completing this unit, the learner will be able to:

- ◊ state the meaning of debenture and explain the difference between debentures and shares
- ◊ describe various types of debentures
- ◊ familiarize the difference between shares and debentures

Prerequisite

Assume a growing company called BlueRiver Constructions Ltd., which needs money to build a new eco-friendly housing project. The company first turns to the public and offers shares. People who buy these shares become owners of the company, share its profits, and take part in its risks. But after some time, BlueRiver still needs more funds. This time, it chooses a different path and issues debentures. People who buy debentures do not become owners; instead, they become lenders who receive a fixed rate of interest, whether the company makes a profit or not. The company must repay this amount after a certain period. Through BlueRiver's choices, we clearly see the difference: shares represent ownership and profit-sharing, while debentures are loans that create a fixed obligation for the company. This simple journey helps learners to understand why companies issue both shares and debentures, and how each serves a different financial purpose.

Keywords

Debentures, Bond, Features of Debentures, Types of Debentures, Distinguish between Shares and Debentures

Discussion

2.1.1 Meaning and Definition of Debentures

The word 'debenture' has been derived from the Latin word 'debere' which means to borrow. A debenture is a written instrument that acknowledge debt and bear company's seal. It outlines a contract for the repayment of the principal amount at specified intervals and includes fixed interest payments, typically semi-annually or annually. The holder of a debenture, known as the debenture holder is a preferential creditor. Companies that intend to raise funds without compromising ownership may issue debenture as means of long-term debt financing.

Section 2 (30) of The Companies Act, 2013, defines debenture as "Debenture includes debenture stock, bonds or any other instrument of a company evidencing a debt, whether constituting a charge on the company's assets or not"

Bonds are also instruments of debt. Traditionally, bonds were issued by the government, but now they are also issued by semi-government and non-governmental organizations. The terms 'debenture' and 'bonds' are now being used interchangeably. However, the instruments referred to in Chapter III-D of the Reserve Bank of India Act, 1934 and such other instruments, as may be prescribed by the Central Government in consultation with the Reserve Bank of India, issued by a company, shall not be treated as debenture.

2.1.2 Features of Debentures

a. **Acknowledgment of debt** : Debenture is a written document that acknowledges debt. It is an instrument used by organisations to raise long-term debt. The agreement between company and debenture holder is known as debenture certificate, which can be presented as a proof in court at the time of winding up of a company.

b. **Fixed Rate** : The interest paid for debentures are fixed, which will be mentioned in the certificate. This rate is called "Coupon Rate". Interest on debenture is payable even if there is a loss . Thus, debenture holders become the company's creditors carrying a fixed interest rate.

c. **Redemption** : Unlike equity, debentures are repaid by the company on the date of maturity. Date of maturity will be mentioned in the debenture certificate. This process is known as redemption.

d. **Secured** : Debentures are secured, because it involves collateral. Collateral can be any asset of the company mentioned in the debenture certificate, against which the debenture holder will have a claim.

e. **Tax-deduction** : Interest payable on a debenture is a charge against profit and hence it is a tax-deductible expenditure.

f. **No voting power :** Debenture holders do not enjoy any voting right

2.1.3 Types of Debentures

A company may issue different debentures that can be categorised based on Security, Redemption, Convertibility, Coupon rate, and Negotiability.

2.1.3.1 On the basis of Security

a. **Secured Debentures**: Secured debentures are those that have a claim against the company's asset in the event of any default. The charge may be fixed or floating. A fixed charge is created on a specific asset whereas a floating charge is on the general assets of the company. Such charge is to be registered with the Registrar of companies (R O C)

   For example: A city might use future property tax receipts to secure a bond while companies might use their factories as bond securities. Secured debentures have less risk associated with them than unsecured one. A factory or office building is a typical example of a fixed charge asset in a secured debenture.

b. **Unsecured Debentures**: Unsecured debentures are those that are issued without providing any claim for the debenture holder on the assets of a company. Unsecured debentures do not have a specific charge on the assets of the company. However, a floating charge may be created on these debentures by default. Normally, these kinds of debentures are not issued. Because the debenture holder will not be able to make any claims against the assets, when company makes any default.

2.1.3.2 On the basis of Redemption

a. **Redeemable Debentures**: Redeemable debentures are those that are redeemable at the end of a specified period, either in a lump sum or in instalments over the company's lifetime. Debentures can be redeemed either at par or at premium. From the point of view of redeemable debenture company issues debenture, for a specific period of time (maximum period of 10 years from the date of issue).

b. **Irredeemable Debentures**: Irredeemable debentures are also known as Perpetual Debentures because the company does not give any undertaking for the repayment of money borrowed by issuing such debentures. These debentures are repayable on the winding-up of a company or on the expiry of a long period.

2.1.3.3 On the basis of Convertibility

a. **Convertible Debentures**: Debentures which are convertible into equity shares or in any other security either at the option of the company or the debenture holders are called convertible debentures.

b. **Non-Convertible Debentures**: The debentures which cannot be converted into shares or in any other securities are called non-convertible debentures. Most debentures issued by companies fall in this category.

c. **Partly Convertible:** Debentures that cannot be fully converted into equity are known as partly convertible debentures. Only a fixed portion of such debentures can be converted to equity by the debenture holders, whereas the rest will remain as debentures until maturity or redemption.

2.1.3.4 On the basis of Negotiability

Debentures issued by the company may be negotiable or non-negotiable.

a. **Bearer Debentures:** These debentures are payable to bearer of the debentures and easily transferable by mere delivery and the company does not have any record of the debenture holder and interest rates. These debentures are also known as unregistered debentures. Usually, coupons are attached with these debentures and interest is paid to the person who produces coupons.

b. **Registered / order Debentures:** These debentures cannot be transferred simply by delivering debenture certificates; instead, they must be transferred in accordance with the Companies Act 2013 by completing transfer deeds and having the transfer recorded by the firm. Debentures that have been registered are not negotiable instruments.

An individual whose name appears on both the debenture certificate and the register of debenture holders maintained by the company, is referred to as a registered holder of a debenture. When principal and interest are due on these debentures, they are payable to the registered holders.

2.1.3.5 On the basis of Coupon Rate

a. **Specific Coupon Rate Debentures**: These debentures are issued with a specified rate of interest, which is called the coupon rate. The specified rate may either be fixed or floating. The floating interest rate is usually tagged with the bank rate.

Suppose you bought a bond of face value Rs 2, 000 and the coupon rate is 10 percent. Every year, you'll get Rs 200 (10 percent of Rs 2, 000), which boils down to an effective rate of interest of 10 per cent.

b. **Zero Coupon Rate Debentures**: These debentures do not carry a specific rate of interest. In order to compensate the investors, such debentures are issued at substantial discount and the difference between the nominal value and the issue price is treated as the amount of interest related to the duration of the debentures.

2.1.4 Distinguish between Shares and Debentures

There are some significant differences between shares and debentures as follows:

Basics	Debenture	Shares
Ownership	It is a debt taken by the company hence Debenture holders are the lenders of the company	It is the capital of the company, so Shareholders are the owners of the company

Return	The return on debenture is known as interest. The rate of return on debenture is predetermined irrespective of whether the company earns profit or not	The return on share is called dividend. Dividend is paid only when the company makes profit, which may fluctuate yearly.
Repayment	Debentures are issued specifically for a period and repayable after the expiry of that period.	Shares are not returned during the lifetime of the company, except for the preference share which is redeemed on the due date.
Voting right	Debenture holders have no voting rights	Shareholders have voting right
Security	Debentures are generally secured and carry a fixed or floating charge over the assets of the company.	Shares are not secured by any charge.
Convertibility	Debentures can be converted into shares	Shares cannot be converted into debentures
Mortgages	Asset of a company mortgaged in favour of debenture holders.	Asset of the company cannot be mortgaged in favour of shareholders.
Purchase	A company can purchase its own debenture from the market without any conditions.	A company can buy-back its own shares, but upon fulfilment of certain conditions
Priority as to repayment during winding-up	Payment of debenture is made before the repayment of share capital.	Payment of share capital is made after the repayment of debentures.

Recap

- ◊ Debenture is an acknowledgment of debt issued to the person lending money.
- ◊ The holder of debenture is known as debenture holders.
- ◊ Debenture has fixed rate of interest known as coupon rate, which is paid to the debenture holder periodically.
- ◊ Debentures can be convertible and non - convertible

- ◊ Debenture holders are creditors of the company, and they do not possess any voting right.
- ◊ Debentures can be redeemable and irredeemable
- ◊ Redeemable debentures are to be repaid in full on the date of maturity
- ◊ Irredeemable debentures are to be repaid in full only at the winding of the company

Objective Questions

1. Debentures redeemed before maturity are called
2. Debentures issued against a claim on the asset of a company is called
3. Debentures that cannot be redeemed during the lifetime of the company are called.
4. Irredeemable debentures are otherwise known as
5. Debentures that can be converted to shares are known as
6. Debentures that can be transferred by mere delivery is known as
7. The fixed interest rate paid by the company on the face value of debenture is known as
8. Debentures that can be transferred according to Companies Act 2013 is known as?

Answers

1. Redeemable debentures
2. Secured debentures
3. Irredeemable debentures
4. Perpetual debentures
5. Convertible debentures
6. Bearer debentures
7. Coupon rate
8. Registered debentures

Self-Assessment Questions

- ◊ Define debentures
- ◊ ‘Debentures are different from bonds. Comment.
- ◊ What are the different types of debentures?
- ◊ Debenture holders do not have voting rights. Explain.
- ◊ Write a short note on debentures based on security.
- ◊ Differentiate between debentures and shares
- ◊ Write a short note on debentures that are negotiable.
- ◊ Write a short note on debentures that are convertible

Assignments

1. Explain the need and significance of issuing debentures.
2. “Debentures are preferred over shares at the time of winding up”. Explain.

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Unit 2

Issue of Debentures

Learning Outcomes

After completing this unit, the learner will be able to:

- ◊ record the journal entries for the issue of debentures at par, at a discount and at a premium
- ◊ explain the concept of debentures issued for consideration other than cash and collateral security, and the accounting thereof

Prerequisite

Assume a company called SilverPath Technologies Ltd., which wants to launch a new smart device. To raise money, the company decides to issue debentures. First, it offers debentures for cash, inviting investors to lend money directly in exchange for a fixed interest. Many people trust the company and buy these debentures, giving SilverPath the funds it needs. As the project grows, SilverPath purchases machinery from a supplier. Instead of paying immediately in cash, it issues debentures as consideration, promising to pay the supplier with interest over time. Later, when the company approaches a bank for an additional loan, the bank asks for security. SilverPath offers debentures as collateral security, meaning the bank will have a claim over these debentures only if the company fails to repay the loan. Through this journey, students can clearly understand how debentures may be issued for cash, for non-cash consideration, and as collateral to secure loans.

Keywords

Issue of Debentures, Types of issue of debentures, Over subscription, Fraction Debentures, Debenture Discount, Interest on Debentures

Discussion

2.2.1 Issue of Debentures

The procedure for issuing debentures is similar to that of issuing stock. Prospective investors submit applications for debentures based on the company's prospectus. The company may ask for payment in full or in instalments for application, allotment, and numerous calls. Debentures can be issued at par, at a discount, or at a premium. Application fees are returned when applications are rejected. In the event of a partial allotment, the remaining application money is adjusted towards subsequent calls. Issue of debenture can be made for consideration or price. Debentures can be issued either for consideration in cash or other than cash or as collateral security. The accounting treatment for issue of debentures is discussed in this unit.

2.2.2 Debentures issued for cash

Debentures issued for consideration in cash can be categorised into following:

1. Debentures issues at par and redeemable at par or at a discount
2. Debentures issued at a discount and redeemable at par or at discount
3. Debentures issues at premium and redeemable at par or at discount
4. Debentures issued at par and redeemable at premium.
5. Debentures issued at a discount and redeemable at premium.
6. Debentures issued at premium and redeemable at premium

2.2.2.1 Issued at par and redeemable at par

When debentures are issued at par, the issue price will be equal to par value. The journal entries will be as follows:

a) For receipt of application money:

Bank A/c Dr.

To, Debenture application A/c

b) For transfer of application money to debentures account:

Debenture application A/c Dr.

To …% Debenture account

Illustration 1

Sankar Ltd. issued 50,000 9% debentures of ₹50 each, payable on application as specified in the prospectus and redeemable at par after three years from the date of issue. Record the required journal entries for the issue of these debentures in the books of Sankar Ltd.

Date	Particulars	L.F	Debit Amount (₹)	Credit Amount (₹)
	Bank A/c Dr. To Debenture application A/c(Debenture application money received)		25,00,000	25,00,000
	Debenture A/c Dr. To 9% Debenture A/c (Application money transferred to 9% debentures account consequent upon allotment)		25,00,000	25,00,000

2.2.2.2 Debentures issued at discount and redeemable at par or at discount

When debentures are issued at a discount, the issue price is lower than their nominal value. The difference between the issue price and the par value is treated as a loss on the issue of debentures, which is amortised over the debenture period. The journal entries for such an issue are as follows:

a) For receipt of application money

Bank A/c Dr.

To Debenture Application A/c

b) At the time of making allotment

Debenture Application A/c Dr.

Discount on issue of debenture A/c Dr.

To …% Debentures A/c

Illustration 2

Sunshine Ltd. issued 10, 000, 9% debentures of ₹100 each at a 10% discount, redeemable at par at the end of the 10th year. The payment terms were ₹40 on application and ₹50 on allotment. Record the necessary journal entries for the issue of these debentures.

Date	Particulars	L.F	Debit Amount (₹)	Credit Amount (₹)
	Bank A/c Dr. To Debenture application A/c (Debenture application money received)		4,00,000	4, 00, 000
	Debenture A/c Dr. To 9% Debenture A/c (Application money transferred to 8% debentures account consequent upon allotment)		4,00,000	4, 00, 000

	Debenture allotment A/c Dr Discount on issue of debentures A/c Dr To 9% Debentures A/c (Amount due on allotment)		5, 00, 000 1, 00, 000	6, 00, 000
	Bank A/c Dr To Debenture Allotment A/c (Money received consequent upon allotment)		5, 00, 000	5, 00, 000

2.2.2.3 Debenture Issued at Premium and Redeemable at par or at discount

When debentures are issued at a premium, the issue price exceeds the nominal value. The premium amount is credited to the securities premium account. The corresponding journal entries for the accounting treatment of such an issued are as follows:

When premium amount is received at the time of application:

a) For receipt of application money

Bank A/c Dr.

To Debenture Application A/c

b) For transfer of application money at the time of allotment

Debenture application A/c Dr.

To .% Debenture A/c

To Securities Premium A/c

When debentures are issued at par or at premium but redeemed at a discount, the company benefits by paying a lesser amount. However, as per the conservatism principle, this gain is not recorded at the time of issue. The application of the securities premium on debentures is governed by Section 52 of the Companies Act, 2013.

Illustration 3

Kaveri Chemicals Ltd. issued 1, 00, 000 10% debentures of ₹50 each at a 10% premium. Payment terms were ₹25 on application, with the balance payable on allotment. The debentures are redeemable at par after five years. All allotment, money, including the premium, was called and fully received. Prepare the necessary journal entries considering the premium was included in the application money.

Date	Particulars	L.F	Debit Amount (₹)	Credit Amount (₹)
	Bank A/c Dr. To Debenture application A/c (Debenture application money received)		25,00,000	25,00,000

	Debenture A/c Dr. To 10% Debenture A/c To Securities premium A/c (Application money transferred to 10% debentures account and securities premium account consequent upon allotment)		25,00,000	 20,00,000 5,00,000
	Debenture allotment A/c Dr To 10% Debentures A/c (Call made consequent upon allotment)		30,00,000	 30,00,000
	Bank A/c Dr To Debenture Allotment A/c (Call made consequent upon allotment money received)		30,00,000	 30,00,000

2.2.2.4 Debentures issued at par and redeemable at a premium

When debentures are redeemed at a premium, an additional entry must be made at the time of their issue and allotment. This entry is necessary to account for the premium payable upon redemption. The Debenture Redemption Premium Account is a personal account that represents a liability for the company regarding the premium payable at redemption. In this scenario, the issue price is the same as the par value, but the redemption value is higher than the debenture's face value at the time of allotment. The following journal entries should be made in this case:

a) For receipt of application money

Bank A/c Dr.
To Debenture application A/c

b) At the time of making allotment

a. Transfer of application money to debenture account

Debenture Application A/c Dr.
To …% Debenture A/c

b. Call made consequent upon allotment

Bank A/c Dr.
Loss on issue of debenture A/c Dr.
To …% Debenture A/c
To Debenture redemption premium A/c

Illustration 4

New Age Ltd. issued 2, 00, 000, 10% debentures of ₹100 payable as follows:

On application ₹30

On allotment ₹70

The debentures were fully subscribed and all the money was duly received. As per the terms of issue, debentures are redeemable at ₹110 per debenture. Record necessary entries regarding issue of debentures.

Date	Particulars	L.F	Debit Amount (₹)	Credit Amount (₹)
	Bank A/c Dr. To Debenture application A/c (Debenture application money received)		60,00, 000	 60,00,000
	Debenture Application A/c Dr. To 10% Debenture A/c (Application money transferred to 10% debentures account consequent upon allotment)		60,00,000	 60,00,000
	Debenture allotment A/c Dr Loss on issue of Debentures A/c Dr To 12% Debenture A/c To Debentures redemption premium A/c (Call made upon allotment of debentures at par and entry for debenture redeemable at premium)		60,00,000 20,00,000	 60,00,000 20,00,000
	Bank A/c Dr To Debenture Allotment A/c (Call made consequent upon allotment money received)		60,00,000	 60,00,000

2.2.2.5 Debentures issued at discount and redeemable at premium

When debentures are issued at a discount and redeemable at a premium, the issue price is less than the par value, while the redemption value is greater than the par value. The difference between the redemption price and the issue price is considered a discount or loss on the issue of debentures. For example, consider a 5% debenture with a par value of ₹100 that is issued at a discount of ₹5 and is redeemable at a premium of ₹2 per debenture. In this case, the amount of loss would be calculated as ₹102 (redemption value) minus ₹95 (issue price), resulting in a loss of ₹7. This amount is treated as a loss on the issue. It is important to note that the premium on the debentures is also credited by ₹2.

a) For the receipt of application money

Bank A/c Dr.

To Debenture application A/c

b) At the time of making allotment

i. Transfer of application money to debenture account

Debenture application A/c Dr.

To .% Debentures A/c

ii. Call made consequent upon allotment of debentures at discount and redeemable at premium

Debenture allotment A/c Dr.

Discount/loss on issue of debenture A/c Dr.[1]

To .% Debenture A/c

To Debenture redemption premium A/c

c) For receipt of call made on allotment

Bank A/c Dr.

To Debenture allotment A/c

Illustration 5

Digitech Ltd. issued 150 9% debentures of ₹100 each at a discount of 6%, redeemable at a premium of 5% after 3 years payable as: ₹50 on application and ₹44 on allotment. Give journal entries.

Date	Particulars	L.F	Debit Amount (₹)	Credit Amount (₹)
	Bank A/c Dr.		7,500	
	To Debenture application A/c			7,500
	(Debenture application money received)			
	Debenture Application A/c Dr.		7,500	
	To 9% Debenture A/c			7,500
	(Application money transferred to 9% debentures account consequent upon allotment)			
	Debenture allotment A/c Dr		6,600	
	Loss on issue of Debentures A/c Dr		1,650	
	To 9% Debenture A/c			7,500
	To Debentures redemption premium A/c			750
	(Call made consequent upon allotment of debenture issued at discount and redeemable at premium)			
	Bank A/c Dr		6,600	
	To Debenture Allotment A/c			6,600
	(Call made consequent upon allotment money received)			

Calculations:

Loss on issue of debentures = (Amount of discount on issue + Premium payable on redemption) x No: of debentures

2 Amount equal to the discount on issue of debenture plus premium on redemption of debenture.

= (6% of ₹100 + 5% of ₹100) x 150

= (₹6 + ₹5) x 150

= 1650

2.2.2.6 Debentures issued at premium and redeemable at premium

In this situation, the issue price of the debentures is higher than their par value, and the redemption value is also above par value. The premium received when the debentures are issued is credited to the Securities Premium Account, while the premium paid at the time of redemption is recorded as a loss at the time of the issuance of the debentures. For example, consider a 10% debenture with a par value of ₹1, 000 that is issued at a premium of ₹100 and is redeemable at a premium of ₹50 per debenture. In this case, ₹100 would be credited to the Securities Premium Account, and ₹50 would be noted as the loss to be accounted for at the time of issuance. It is important to mention that the premium on debentures is also credited by ₹50.

(a) For the receipt of application money

Bank A/c Dr.

To Debenture application A/c

(b) At the time of making allotment

a. Transfer of application money to debenture account

Debenture application A/c Dr.

To ...% Debentures A/c

b. Call made consequent upon allotment of debenture at premium and redeemable at premium

Bank A/c Dr.

Loss on issue of Debentures A/c Dr.

To Securities premium A/c

To Premium on redemption of debentures A/c

The debenture application a/c and debenture allotment a/c are closed after the allotment of debentures.

2.2.2.7 Debenture payable in instalments

Just like shares, money payable on debentures may be paid in full with application or by instalments. Accounting entries will vary to some extent in either case

Debenture payable in full on application

When the total amount due on debentures is payable in full at the time of application, it is common practice to open a separate Debentures Application Account for each class of debentures, such as a 10% Debentures Application Account or a 12% Debentures Application Account. These accounts track the funds received from applicants for the debentures. If the issue is oversubscribed, these accounts are also used to document the refunds issued to unsuccessful applicants. At the time of debenture allotment, the funds in the Debentures Application Account are transferred to the respective Debentures Account.

Debentures Issued at Par: Debentures issued at par are sold at their nominal value. For example, if a debenture has a nominal value of ₹100, it is issued at par, meaning the company receives ₹100 for it. The accounting treatment for these transactions will be as follows:

a) When cash is received

Bank A/c Dr.

To Debenture application A/c

(Being money received on …debentures @ ₹…each)

b) When excess money is refunded or adjusted for future calls

Debentures application A/c Dr.

To Bank A/c (Amount refunded)

To Debenture allotment A/c (Amount adjusted for allotment)

(Being excess money …debentures adjusted as per Board's Resolution No… Dated….)

c) When the debentures are allotted

Debentures application A/c Dr.

To …% Debentures A/c

(Being the allotment of ….debentures of ₹…each as per Board's Resolution No… Dated…)

d) On allotment money being called

Debenture allotment A/c Dr.

To % Debentures A/c

(Being allotment money called)

e) On allotment money being received

Bank A/c Dr.

To Debenture allotment A/c

(Being allotment money received)

f) On debenture call money being called

Debenture calls A/c Dr.

To % Debentures A/c Dr.

(Being call money made due)

g) On debenture call money being called

Bank A/c Dr.

To Debenture calls A/c

(Being call money received)

Illustration 6

Naturals Ltd. issued 10, 000 12% debentures of ₹10 each at par payable in full on application by 1st April. Applications were received for 11, 000 debentures. Debentures were allotted on 7th April. Excess money was refunded on the same date. Give journal entries.

Date	Particulars	L.F	Debit Amount (₹)	Credit Amount (₹)
April 1	Bank A/c Dr.		11,0000	
	To Debenture application A/c			11,0000
	(Debenture application money received)			
April 7	Debentures Application A/c Dr.		10, 000	
	To Bank A/c			10,000
	(Money on 10, 000 debentures refunded as per Board's Resolution)			
April 7	Debenture application A/c Dr.		1,00, 000	
	To Debenture A/c			1,00,000
	(Being the allotment of 1, 00, 000 debentures of 100 each at par, as per Board's Resolution)			

Debenture issued at a premium: A company issues debentures at a premium when the market interest rate is lower than the interest rate on the debentures. When debentures are issued at a premium, they are sold at a price higher than their nominal value. For instance, if a debenture with a nominal value of ₹100 is issued at a 10% premium, the company will receive ₹110. Investors, however, will receive slightly less interest than the stated rate due to the premium.

Section 52(2) of the companies Act 2013 deals with the use of the amount received as premium on securities: The amount received as premium on securities is restricted to the following purposes only

- ◊ Issuing fully paid bonus shares to the existing shareholders
- ◊ Writing off any preliminary expenses of the company
- ◊ To write off any expenses or commission paid or discount allowed on any issue of securities or debentures of the company
- ◊ To provide for the premium payable on the redemption of any redeemable preference shares or any debentures of the company

◊ For use of buy back of shares

For example, on a 12% debenture with a nominal value of ₹100 issued at a 10% premium, the investor will earn ₹12 per annum on their investment of ₹110. As a result, the effective rate of interest on the investment is calculated as follows: (12/110) x 100 = 10.91%. The accounting treatment for such situations is outlined below:

a) When cash is received

Bank A/c Dr.

To Debenture application A/c

(Being money received on … debentures @ ₹… each including a premium of ₹….)

b) When excess money is refunded

Debentures application A/c Dr.

To % Bank A/c

(Being refund on money on … debentures @ ₹… each as per Board's Resolution No… Dated.)

c) When the debentures are allotted

Debentures application A/c Dr.

To % Debentures A/c

To Securities premium A/c

(Being the allotment of … debentures, premium as per Board's Resolution No… dated…)

Debentures issued at a discount: The Companies Act allows debentures to be issued at any price, including at a discount, which is common. For example, a ₹100 debenture at a 10% discount is issued for ₹90. This raises the effective interest rate; for 125 debentures of ₹100 issued at a 10% discount, the company pays ₹12 interest on ₹90, resulting in a true interest of 13.33%. Debentures are typically issued at a discount when market interest rates exceed the debenture rate. The nominal value is credited to the debenture account, and the discount is recorded separately, amortized over 3-5 years without exceeding the debenture tenure. Discount on issue of debentures to be written off within 12 months of the balance sheet date or the period of operating cycle is shown under 'Other Current Assets' and the part which is to be written off after12 months is shown under 'Other Non –current Assets'

The companies Act 2013 does not impose any restrictions upon the issue of debentures at a discount.

Illustration 7

a) When cash is received

Bank A/c Dr. (Actual cash received)

To Debentures Application A/c

(Being money received on … debentures @ ₹… each)

b) When excess money is refunded

Debentures application A/c Dr.

To Bank A/c

(Being excess money on … debentures refunded as per Board's Resolution No… dated …)

c) When the debentures are allotted

Debentures application A/c Dr.(Actual cash received)

Discount on issue of debentures A/c Dr.(Discount on debentures)

To Debentures A/c (Nominal value of debentures)

(Being the allotment of …. Debentures of ₹ … each @ ₹… each as per Board's Resolution No… dated …)

Illustration 8

XYZ Ltd issued 10, 000 9% debentures of ₹10 each at a discount of 10% payable in application by 31st July, 2024. Applications were received for 12, 000 debentures. Debentures were allotted on 9th August, 2024. Excess money was refunded on the same date. Give journal entries and prepare necessary ledger accounts.

Date 2022	Particulars	L.F	Debit Amount (₹)	Credit Amount (₹)
July 31	Bank A/c Dr.		10,8000	
	To Debenture application A/c			10,8000
	(Debenture application money received)			
August 9	Debentures Application A/c Dr.		18,000	
	To Bank A/c			18,000
	(Excess money refunded)			
August 9	Debenture application A/c Dr.		9,0000	
	Discount on issue of debentures A/c Dr.		10,000	
	To 9% Debenture A/c			1,00,000

	(Being the allotment of 1, 00, 000 debentures of 100 each at a discount of 10 per debenture as per Board's Resolution)			

Bank Account

Date	Particulars	Amount	Date	Particulars	Amount
31.7.2022	To 9% Debentures application A/c	1, 08, 000	9.8.2022	By 12% Debentures Application A/c	18,000
			9.8.2022	By Balance c/d	90,000
		1, 08, 000			1, 08, 000

9% Debentures account

Date	Particulars	Amount	Date	Particulars	Amount
31.7.2022	To Balance c/d	1, 00, 000	9.8.2022	By 9% Debentures Application A/c	90,000
			9.8.2022	By Discount on issue of debentures A/c	10,000
		1, 00, 000			1,00,000

Debentures Application Account

Date	Particulars	Amount	Date	Particulars	Amount
9.8.2022	To Bank A/c	18, 000	31.7.2022	By Bank A/c	1,08,000
9.8.2022	To 12% Debentures A/c	90, 000			
		1, 08, 000			1,08,000

Discount on Issue of Debentures Account

Date	Particulars	Amount	Date	Particulars	Amount
9.8.2022	To 9% Debentures application A/c	10,000	30.7.2022	By Balance c/d	10,000
		10,000			10,000

2.2.3 Debenture issued for consideration other than cash

When debentures are issued to vendors as part of the purchase consideration, this is known as the issue of debentures for consideration other than cash. The journal entries in this case will be:

(i) For purchase of assets

Sundry assets A/c Dr.

To Sundry liabilities A/c

To Vendors A/c

(ii) For issuing debentures for payment of purchase consideration

Vendor A/c Dr.

To, Debentures A/c

2.2.4 Debentures Issued as Collateral Security

When debentures are issued as subsidiary or secondary security in addition to the primary security for a loan or bank overdraft, this type of debenture is known as collateral security. The main objective of issuing collateral security is to provide the bank with additional protection. If the company fails to repay the loan and the main security is insufficient, the bank has the right to sell the debentures in the market or keep them for its own purposes. If the company successfully repays the loan, the bank will return the debentures issued as collateral security to the company.

Debentures issued as collateral security can be managed in two ways:

(i) **First Method**: When debentures are issued as collateral security, no entry in the company's books is required. Debentures only come to life when a debt is not paid back. It is disclosed under the head Secured loans in the Equity and Liabilities part of the Balance Sheet.

(ii) **Second Method**: Following Journal Entry can be passed for the issue of debentures as collateral security:

Debenture Suspense Account Dr.

To Debentures Account

At the time when loan is paid to the lender, this entry will be reversed to cancel or nullify the effect of entry already passed. In Balance sheet, such debentures are disclosed separately from the other debentures.

Illustration 9

AB Ltd borrowed rupee 30, 00, 000 from a bank at an annual interest rate of 12% and deposited 14% debentures of the face value of 45, 00, 000 as collateral security. Pass the journal entries regarding the issue of debentures as collateral security and also show the above items in the company's Balance sheet

In the Book of AB Ltd.

JOURNAL

Debenture Suspense A/c Dr To Debentures A/c (14% Debenture issued to the Bank as collateral security)	45,00,000	45,00,000

BALANCE SHEET OF AB LTD

Particulars	Notes No.	Amount	Amount
Equity and Liabilities			
1. **Non-Current liabilities**			
Long term borrowings	1	30, 00, 000	
Total		30, 00, 000	
Assets			
2. **Non- Current assets**			
Other non-current assets			
3. **Current assets**			
Cash and cash equivalent		30, 00, 000	
Total		30, 00, 000	
Notes to accounts			
		Amount	**Amount**
1. **Long term Borrowings**			
Secured loan			
AB Ltd loan			30,00,000
14% Debentures		45,00,000	
Debenture suspense			

Note: "Loss on Issue of Debentures" and "Discount on Issue of Debentures" are capital losses that will appear on the Balance Sheet as intangible assets. These accounts will be written down against the Profit and Loss Account or the Security Premium Account, whichever comes first.

The terms "premium on debenture account" and "premium on redemption of debenture account" are not interchangeable. When debentures are issued at a premium, the Premium on Debentures Account is raised, whereas the Premium on Redemption of Debentures Account is only raised if the debentures are to be redeemed at a premium. The former reflects a capital profit and is recorded under the heading Reserves and Surplus, while the latter represents a liability provision to be paid at the time of the transaction

Recap

- ◊ A debt can be issued for cash or other than cash.
- ◊ Acting as collateral security
- ◊ Issue debentures at a par, at a premium or at a discount.
- ◊ Sometimes debenture application money exceeds par value
- ◊ Capital losses include loss on debenture issuance and discount on debenture issuance

Objective Questions

1. When debenture is issued at discount how is the difference between issue price & parvalue treated ?
2. Where does issue price exceeds the nominal value of debentures?
3. What liability does Debentures Dedemption Account 'Prepresent'?
4. What do you call a debenture when it is issued as security against loan or Bank DD?
5. On the issue of debentures as a collateral security, which account is credited?
6. Which account is credited with the issue of debentures as a collateral security?
7. When debentures are to be redeemed at a premium, an extra has to be paid at the time of issue of the debentures. Which account should be credited in this entry?

Answers

1. Treated as loss on issue of debentures
2. Debentures issued at premium
3. Premium payable on redemption
4. Callateral security
5. Debenture Account
6. Debentures Suspense Account
7. Debenture Redemption premium Account

Self Assessment Questions

- ◊ What is the nature of the premium on redemption of a debenture account? Ans: Personal Account
- ◊ Lotus Ltd. issued 1, 50, 000 8% debentures of ₹150 each at a premium of 5% payable fully on application and redeemable at premium of ₹10. Give necessary journal entries at the time of issue of debentures.
- ◊ Herbal Chemicals Ltd. issued 10, 00, 000, 10% debentures of ₹50 each at a premium of 10% as ₹25 on application and balance on allotment. Debentures are redeemable at par after 6 years. All the money due on allotment was called up and received. Give journal entries when premium money is included with allotment money
- ◊ Vignesh Ltd issued 60, 000 10% debentures of ₹100 each at a premium of 10% payable in full on application by 1st March, 2024. The issue was fully subscribed and debentures were allotted on 9th March 2024. Give journal entries including cash transactions.

Assignments

1. Explain the different modes of issuing debentures.
2. On 1st May 2024 Ivory Ltd issued 10, 000 12% debentures of ₹10 each at a discount of 5% redeemable on 30th June 2029. Issue was oversubscribed by 2, 000 debentures and the money was refunded. Interest is paid annually on 31st March. You are required to prepare:
   a. Journal entries at the time of issue of debentures.
   b. Discount on issue of debenture account
   c. Interest account and debenture holder account.

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Unit 3

Redemption of Debentures

Learning Outcomes

After completing this unit, the learner will be able to:

- ◊ get an overview of the debenture redemption process
- ◊ identify the requirements for establishing a Debenture Redemption Reserve and Debenture Redemption Fund
- ◊ gain knowledge about the various debenture redemption methods
- ◊ recognize the debenture redemption accounting treatment
- ◊ solve problems regarding debenture redemption

Prerequisite

Imagine a company called Harmony Textiles Ltd., which had earlier borrowed money by issuing debentures to finance a new factory. The investors who bought these debentures became lenders and received regular interest every year. As time passes, the company becomes profitable and the due date for repayment approaches. Harmony Textiles now prepares to redeem its debentures, which means paying back the original amount borrowed to the debenture holders. Some debentures are redeemed in one lump sum, while others are repaid gradually through a sinking fund the company had set aside earlier. The moment the last payment is made, the debenture holders' rights come to an end, and the company becomes free from that debt. This simple journey helps learners to understand that redemption of debentures is the process of repaying borrowed funds and closing the company's liability towards debenture holders.

Keywords

Redemption of a Debentures, Sources of redemption of Debentures, Methods of redeeming Debentures, Own Debentures, Interest on Own Debentures, DRR, Interest on Debenture, Discount on Debentures

Discussion

2.3.1 Redemption of Debentures

Meaning:

"Redemption" is derived from the Latin word "redimere." This term is made up of two words:'re(d)' and 'emere.' 'Re (d)' indicates "back, " while "emere" signifies "purchase." The act of purchasing something that was previously sold is hence the critical meaning of redemption. The phrase "redemption" in accounting refers to the repayment of a debt or security's principal amount at or before maturity. Thus, redemption of debentures simply means repayment of debentures. It is the discharging of the liability on account of debentures. They may be redeemed at par or at premium.

Under section 71 (1) of the Companies Act, 2013, a company may issue debentures with option to convert such debentures into shares, either wholly or partly at the time of redemption.

Provided that the issue of debentures with an option to convert such debentures into shares, wholly or partly, should be approved by a special resolution passed at a duly convened general meeting.

Section 71 (2) further provides that no company can issue any debentures which carry any voting rights.

Section 71 (4) provides that where debentures are issued by a company, the company should create a debenture redemption reserve account out of the profits of the company available for payment of dividend and the amount credited to such account should not be utilised by the company for any purpose other than the redemption of debentures.

2.3.1.1 Basic Provisions

If a charge has been placed on any asset or the entire company's assets, the nature of the charge, the asset (s) charged are described therein because the charge isn't legal unless it's registered with the registrar, the registrar’s certificate is printed on the bond. When it comes to mortgage debentures, it's also common to set up a trusteeship in the name of one or more people. The trustees of debenture holders have all of the powers of a mortgagee and can act in any way they see fit to protect the debenture holders’ interests.

As per the rule 18(2) of the Companies (Share capital & Debentures) Rule, 2014, the company shall appoint debenture trustees as requires under sub-section (5) of section 71 of the Companies Act 2013, after complying with certain conditions mentioned in the rule.

2.3.1.2 Situations for Redemption of Debentures

Debentures are usually redeemable in cash or equity after a time period. Redeemable debentures may be redeemed during the lifetime of the issuing company. A company may also purchase its debentures, as and when convenient, in the open market and when debentures are quoted at a discount on the Stock Exchange, it may be profitable for the company to purchase and cancel them.

2.3.1.3 Sources of Redemption of Debentures

When a company issues Debentures it usually mentions the terms on which they will be redeemed on their maturity. Redemption of debentures means discharge of liability on account of debentures by repayment made to debenture holders. Debentures can be redeemed either at par or at a premium.

1. Out of fresh issue of shares/ debentures
2. By utilisation of a part of capital
3. By utilisation of accumulated profits
4. By conversion in to shares/ debentures
5. Out of proceeds from sales of fixed assets
6. By purchase of own debentures

2.3.2 Methods of Redeeming Debentures

As we know, debentures are debt instruments, hence when their period expires, the debenture holders are paid back their principal amount. This process of discharging the company's debt is known as the redemption of debentures. Redemption of debentures must be done according to the terms of issue of debentures and any deviation therefrom will be treated as a default by the company. There are four ways by which the debentures can be redeemed:

2.3.2.1 Redemption of Debentures by Lump-sum Method

Under this method, the entire number of debentures is redeemed after the expiry as per the terms of the issue. In other words, the entire amount of the debenture is paid in one lump-sum to the debenture holders, as per the conditions of the issue, at the end of the life of the debenture.

2.3.2.2 Redemption by payment in instalments

Under payment in instalments method, normally redemption of debentures is made in instalments on the specified date during the tenure of the debentures. The total amount of debenture liability is divided by the number of years. It is to note that the actual debentures redeemable are identified by means of drawing the requisite number of lots out of debentures outstanding for Payment.

2.3.2.3 Purchase in open market

When a company purchases its own debentures for the purposes of cancellations, such an act of purchasing and cancelling the debentures constitutes redemption of debentures by purchase in the open market.

2.3.2.4 Conversion into shares or new debentures

If the company issues fully or partly convertible debentures that company can redeem its debentures by converting them into shares as per the terms of issue. In some cases, companies may issue new class of debentures or convert debentures into shares in consultation with debenture holders eligible for redemption, If the debenture holders find that the offer is beneficial to them, they may accept the offer and exercise their right of converting their debentures into shares or new class of debentures.

Debenture Redemption Reserve Account

When a company issues debentures, it may be required to establish a Debenture Redemption Reserve account using profits available for dividend distribution. The funds credited to this account can only be used for the purpose of redeeming debentures. This arrangement ensures that the company will have sufficient liquid assets available for the redemption of debentures when they come due. Each year, an appropriate amount is transferred from profits to the Debenture Redemption Reserve, and the investments made from this reserve are referred to as Debenture Redemption Reserve Investments (or Debenture Redemption Fund). In the final year or at the time of debenture redemption, the Debenture Redemption Reserve investments are liquidated, and the proceeds are used for the redemption of the debentures. The journal entries for redeeming debentures using profits are as follows:

1. After allotment of debentures

a) **For setting aside the fixed amount of profit for redemption**

Surplus/profit and loss Account Dr.

To Debenture redemption reserve A/c

b) For investing the amount set aside for redemption

Debenture Redemption Investment A\c Dr

To Bank A/c

c) For receipt of interest on debenture redemption reserve investments

Bank A/c Dr.

To Interest on debenture redemption investment A/c

d) **For transfer of interest on debenture redemption investments (DRRI)**

Interest on debenture redemption reserve investment A/c Dr.

To Profit and loss A/c

2. At the time of redemption of debentures

a) **For encashment of debenture redemption reserve investments**

Bank A/c Dr.

To Debenture Redemption Reserve investment, A/c

b) **For Amount due to debenture holders on redemption**

Debentures A/c Dr.

To Debenture holder's A/c

c) **For Payment to debenture holders**

Debentures holder's A/c Dr.

To Bank A/c

d) **After redemption of debentures, DRR should be transferred to general reserve**

DRR A/c Dr.

To General Reserve

Illustration 1

The following balance appeared in the books of a company as on December 31, 2023.

6% Mortgage 10, 000 debenture of ₹100 each.

Debenture redemption reserve (for redemption of debentures ₹50, 000

Investments in deposits with a scheduled bank, free from any charge or lien ₹1, 50, 000 at interest 4% per annum receivable on 31st December every year.

Bank balance with the company is ₹9, 00, 000

The interest on debentures had been paid up to December 31 2023.

On February 28, 2024 the investments were realised at par and the debentures were paid off at 101, together with accrued interest. Prepare the necessary ledger accounts.

6% Mortgage debentures account

2024	Particular	Amount	2024	Particulars	Amount
Feb.28	To Debenture holder's A/c	10,00,000	Jan.1	By Balance c/d	10,00,000

Premium on redemption of debentures account

2024	Particular	Amount	2024	Particulars	Amount
Feb.28	To Debenture holder's A/c	10, 000	Feb.28	By Profit and loss, A/c	10,000

Debentures redemption reserve investment account

2024	Particular	Amount	2024	Particulars	Amount
Jan.1	To Balance c/d	1, 50, 000	Feb.28	By Bank	1, 50, 000

Debenture interest account

2024	Particular	Amount	2024	Particulars	Amount
Feb.28	To Bank (10, 000 x 100 x 6% x 2/12)	10, 000	Feb.28	By Profit and Loss, A/c	10, 000

Bank A/c

2024	Particular	Amount	2024	Particulars	Amount
Jan.21	To Balance c/d	9, 00, 000	Feb.28	By Debenture holders (10, 000 x 101)	10,10,000
Feb 28	To Interest on debentures redemption investments (1, 50, 000 x 4% x 2/12)	1000			
	To Debentures redemption reserve investment, A/c	1, 50, 000		By Debenture Interest A/c	10, 000
				By Balance c/d	31,000
		10, 51, 000			10,51,000

Debenture redemption reserve account

2024	Particular	Amount	2024	Particulars	Amount
Feb.28	To General reserve note	1, 00, 000	Jan.1	By Balance b/d	50,000
			Jan.1	By Profit & Loss b/f	50, 000
		1, 00, 000			1, 00, 000

Recap

- ◊ Redemption of Debentures refers to the repayment of the principal amount to debenture holders either on maturity or before maturity.
- ◊ Sources of Redemption of Debentures are the funds used by a company to repay debentures, which may include profits, fresh issue of shares or debentures, a sinking fund, or the Debenture Redemption Reserve (DRR).
- ◊ Methods of Redeeming Debentures explain the different ways in which debentures can be repaid, such as lump sum payment, installment method, purchase from the open market, conversion into shares, and the sinking fund method.
- ◊ Own Debentures are the debentures purchased by the company from the open market either for cancellation or for investment purposes.
- ◊ Interest on Own Debentures means that when a company holds its own debentures, any interest paid is only an internal adjustment and is not treated as an expense of the company.
- ◊ Debenture Redemption Reserve (DRR) is a statutory reserve created by companies to ensure that sufficient funds are available for the redemption of debentures.
- ◊ Interest on Debentures is the fixed return paid to debenture holders as compensation for lending money to the company.
- ◊ Discount on Debentures arises when debentures are issued at a price lower than their face value, and the difference is treated as a loss to the company and written off gradually over time

Objective Questions

1. A debenture that is redeemable (payable) at a fixed and specified period of time is called
2. At the time of liquidation, who will get the first priority at the time of repayment?
3. From where is interest paid on debentures charged?
4. When debentures are issued at par and are redeemable at a premium, the loss on such an issue is debited to which account?

5. The excess value of net assets over purchase consideration at the time of the purchase of a business is credited to which account?
6. In which account is the balance of the redemption fund account transferred?
7. Why does a company purchase its own debentures on the open market?

Answers

1. Maturity period
2. Debenture holder
3. Charge for profit
4. Loss on issue of debentures to account
5. Capital Reserve
6. General Reserve
7. For cancellation or investment.

Self-Assessment Questions

◊ Explain what is meant by redemption of debentures

◊ Write a short note on debenture redemption reserve.

◊ DK Ltd issued ₹4, 00, 000, 10% debentures on 1.04.2020. on 31.3.21, the company decided to redeem ₹40, 000, debentures. Give journal entries for the redemption of debentures.

◊ X Ltd. decided to redeem ₹50, 000, debentures at a premium of 10%. Give journal entries for redemption of the debentures.

Assignments

1. Explain the process of redemption of debentures and the modes of redeeming debentures.

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3

BLOCK

Final Accounts of Companies

Unit 1 Final Accounts

Learning Outcomes

After completing this unit, the learner will be able to:

- ◊ get an overview of the concept of a company
- ◊ explain the different types of companies
- ◊ familiarise with the statutory records to be maintained by companies

Prerequisite

A group of young entrepreneurs who come together to start *BrightFuture Innovations Ltd.*, a business aimed at creating eco-friendly household products. As they begin their journey, they quickly realise that running a business is more than just having a good idea it requires a proper structure, legal identity, and clear rules. This leads them to understand the meaning of a company: an organisation that is created by law, enjoys a separate legal identity, and continues to exist even if its members change. As BrightFuture grows, the founders learn that there are different types of companies, such as private companies, public companies, and those limited by shares or guarantee, each serving different business purposes. They also discover the importance of statutory records, which are official documents a company must maintain like registers of members, minutes of meetings, and records of charges to ensure transparency and compliance with legal requirements. Through the experience of BrightFuture, learners will get a clear starting point for understanding what a company is, how it can be organised, and why maintaining statutory records is essential for smooth and lawful operations.

Keywords

Company, Types, Final Accounts, Statutory Books

Discussion

3.1.1 Meaning & Definition of a Company

A Company is a voluntary and autonomous association of persons with capital divided into numerous transferable shares formed to carry out a particular purpose in common. It is an artificial person created by law to achieve the object for which it is formed. Section 2(20) of the Companies Act, 2013"company" means a company incorporated under this Act or any previous Company law. Commonly a company may be defined as " A registered association which is an artificial legal person, having an independent legal entity with perpetual succession, a common seal for its signatures a common capital comprised of transferable shares and carrying limited liability ". An existing company means a company formed and registered under any of the former Companies Acts.

A company is an arrificial person, invisible, intangible and existing only in the contemplation of law. It can hold, purchase or sell both movable and immovable property, incur and pay debts, open a bank account in its own name and sue and be sued in the same manner as an individual. Law creates it and law only can dissolve it. Its existence is altogether independent of the life of its members. Members may come and go but the company would go on forever. Transferability of shares has given perpetual succession to a company. Death, insanity or insolvency of a member or any member will not affect the existence of the company at all.

A company is a legal entity quite distinct and separate from the persons who are its members. A company can buy its own shares under certain conditions. A shareholder is not the agent of the company. He cannot incur any debt so as to bind the company. Shareholders cannot bind the company by their acts. The same person can be a shareholder and a creditor of the company. The ownership is seperated from management because a joint stock company is managed by a Board of Directors elected by the shareholders (i.e. Owners).

The never-ending human desire to grow and grow further has given rise to the expansion of business activities, which in turn has necessitated the need to increase the scale of operations so as to provide goods and services to the ever-increasing needs of the growing population of consumers. Large amount of money, modern technology, large human contribution etc. is required for it, which is not possible to arrange under partnership or proprietorship. To overcome this difficulty, the concept of 'Company' or 'Corporation' came into existence.

As a form of organisation, the word 'company' implies a group of people who voluntarily agree to form a company.

The word 'company' is derived from the Latin word 'com' i.e. with or together and 'panis' i.e. bread. Originally the word referred to an association of persons or merchant men discussing matters and taking food together.

According to Prof. L .H HANEY:"A company is an artificial person created by law, having seperate entity, with a perpectual succession and common seal".

3.1.2 Characteristics of a Joint Stock Company

We have seen many definitions of a company, from the above definitions following are the characteristicsof a joint stock company

a. Artificial person : A joint stock company is an artificial person as it does not possess any physical attributes of a natural person and it is created by law.

b. Separate legal entity : Being an artificial person, a company has its own legal entity separate from its members. It can own assets or property, enter into valid contracts, sue or can be sued by anyone in the court of law. Its shareholders cannot be held liable for any conduct of the company.

c. Perpetual existence : A company continues to exist as long as it is fulfilling all the conditions prescribed by the law. The death, insolvency, in sanity or retirement of a shareholder won't affect the existence of a company.

d. Limited liability : Shareholders of a joint stock company are only liable to the extent of face value of shares they hold in a company and not more than that. The liability of shareholders is limited to the extent of amount guaranteed or face value of shares

e. Common seal : Being an artificial person a joint stock company cannot sign any documents, thus this common seal is company's signature (representative) while dealing with outsiders. Any document having common seal and the signature of authorised signatory is binding on the company.

f. Transferability of shares : Members of a company can freely transfer their shares through authorised stock exchange, or as per the guidelines of SEBI.

g. Capital : A joint stock company can raise huge amount of capital by issuing shares.

h. Management : A joint stock company is managed by the elected representatives of shareholders called Directors. It has a democratic management.

i. Membership : To form a private limited company minimum number of members prescribed in the companies Act is 2 and the maximum number is 200, where as in the case of public company, the minimum number of members is 7 and there is no limit to the maximum number.

3.1.3 Types of Companies

Entrepreneurs can in corporate different types of companies under the Companies Act, 2013 ('Act') in India to conduct their business and provide a legal structure for the business .

The different types of companies are as follows.

On the basis of Incorporation : There are two ways in which companies may be incorporated, which are as follows:

a. Statutory Companies: A company formed by passing a Special Act in the Parliament is called a Statutory Company or Statutory Corporation.

b. Registered Companies: Those companies which are incorporated under the Companies Act, 2013 or under any previous company law.

Chartered companies were formed by Royal charters. The powers and the nature of businesses of a chartered company are defined by the charter which incorporates. After India got independence-chartered companies do not exist in India E.g. Bank of England (1694), East India company (1600)

On the basis of Liability: Under this category there are three types of companies:

a. Company Limited by Shares: As per Companies Act 2013 section 2(22)A Company limited by shares may be defined as a "registered company" whether public or private company, having the liability of its members limited by its shares, if any, unpaid on the shares respectively held by them. In other words, a member of a company limited by shares is required to pay only the nominal amount of shares held by him and nothing more. If the shares are fully paid-up, he has nothing more to pay.

b. Company Limited by Guarantee: A Company Limited by Guarantee is a registered company having the liability of its members limited by its Memorandum to such an amount as the members may respectively undertake by the memorandum to contribute to the assets of the company in the event of its being wound up.

c. An Unlimited Liability Company: As per section 2(92) of the Companies Act 2013, an Unlimited Company is a company not having any limit on the liability of its members. Thus, the maximum liability of the members of such a company in the event of its being wound up, might stretch up to the full extent of their properties to meet the obligations of the company by contributing to its assets. However the member of an unlimited company are not liable directly to the creditors of the company in the case of partners of a firm.

On the basis of Ownership : Under this category there are three types of companies:

Private Company[Section2(68)]-A Private Company is a type of company that operates with certain restrictions to maintain greater control among a smaller group of shareholders. According to Section 2(68) of the Companies Act, 2013, a private company limits its number of shareholders to 200 and restricts the transfer of its shares. Additionally, it is prohibited from inviting the public to subscribe to its securities, meaning it cannot raise funds by offering shares or debentures to the general public. The company must have at least two members and two directors, and it is required to include "Private Limited" at the end of its name.

Public Company- is a company that does not have the restrictions imposed on private companies. It can have an unlimited number of shareholders and is allowed to invite the public to subscribe to its shares and other securities. Public companies are typically larger and more transparent in their operations, often listed on stock exchanges, allowing public investors to buy and sell shares. To be formed, a public company requires a minimum of seven members who must subscribe their names to a memorandum and fulfill the necessary registration requirements.

One Person Company(OPC) – Section 2(62) of the Companies Act 2013 defines a "one person company" as a company that has only one person as its member. It is a new class of company which can be incorporated by a single person. Furthermore, members of a company are nothing but subscribers to its or its shareholders. Entrepreneurs whose business lie in early stages prefer to create OPCs instead of sole proprietorship business because of the several advantages that OPC offers.

Other forms of Companies- Apart from the above mentioned, there are some other forms of companies such as:

a. Associations not for profit having license under Section 8 of the Companies Act, 2013 or under any previous company law;
b. Government Companies; Section2(45)
c. Foreign Companies; Section 2(42)
d. Holding and Subsidiary Companies; Section 2(46)
e. Associate Companies/Joint Venture Companies Section 2(6)
f. Investment Companies (Section 186)
g. Producer Companies (Section378 A and B)
h. Dormant Companies (Section 455)
i. Nidhi Companies(Section 406)
j. Non-Banking financial companies(NBFC)

3.1.4 Statutory Records

It is a requirement of the Companies Act 2013 that all companies maintain up-to-date statutory registers that can be maintained in electronic format also. Certain guidelines under the Companies Act are required to be followed for the maintenance of the registers and records in electronic format.

List of Statutory Registers

- Register of renewed and duplicate share certificates- As per Share Capital and Debentures Rules, 2014.
- Register of Sweat Equity Shares- As per Share Capital and Debentures Rule, 2014.
- Register of Charges and Instrument of charges- As per Companies (Registration of Charges) Rule, 2014.
- Register of bought back Securities- As per share capital and Debentures Rules, 2014.

- Register of deposits- As per Companies (Acceptance of deposits) Rules, 2014.
- Register of members- As per Rules of the Companies (Management and Administration) Rules, 2014
- Register of any other security holders.
- Register of Debenture-holders
- Index of members-As per Companies management and administration) Rules, 2014.
- Copies of Annual Returns-As per Companies (Management and Administration) Rules, 2014.
- Minutes Book of Board of Directors and Committees of the Board- As per Companies (Management and Administration) Rules, 2014.
- Attendance Registers for the meeting of Board and committee-As per Secretarial Standards-SS-1
- Minutes of General Meetings and Creditors meeting-As per Companies (Management and Administration) Rules, 2014.
- Register of directors and key managerial personnel including details of securities held by them – As per Companies Rules, 2014.
- Register of loans/guarantee/security and investments
- Register of investment in shares or securities not held in the name of the company.
- Register Contracts, with Directors, Companies, and Firms in which Directors are interested.
- Contracts entered into by the company for the appointment of a Manager or Managing Director

Company is thus, a distinct legal entity created by law to achieve specific purposes, characterized by its ability to own property, incur debts, and perpetuate its existence independent of its members.

Recap

- ◊ Company is a voluntary and autonomous association persons.
- ◊ Capital of a company is divided into numerous transferable shares.
- ◊ Chartered Company is Company created by the grant of a charter by the Crown.
- ◊ Statutory Companies is a Company formed by passing a Special Act in the Parliament.
- ◊ Registered Companies are Incorporated under the Companies Act, 2013 or under any previous company law.
- ◊ Company Limited by Shares means Liability of its members limited by its shares.
- ◊ Company Limited by Guarantee means Liability of its members limited by the amount agreed by the members to be contributed at the time of winding up.
- ◊ Unlimited liability Company means a Company not having any limit on the liability of its members.
- ◊ Companies Act 2013 that all companies maintain up-to-date statutory registers that can be maintained in electronic format also.

Objective Questions

1. What is the legal definition of a company according to Section 2(20) of the Companies Act, 2013?
2. What kind of person is a company in the eyes of the law?
3. What characteristic of a company ensures its existence continues despite changes in membership?
4. From which Latin words is the term 'company' derived?
5. What type of company is formed by a grant of a charter by the Crown?
6. How many shareholders can a private company have according to Section 2(68) of the Companies Act, 2013?
7. What is the minimum number of members required to form a public company?
8. Who defined a company as "an artificial person created by law with a perpetual succession and a common seal"?

9. Which type of company has its liability limited by the unpaid amount on shares held by its members?
10. What type of company has no limit on the liability of its members?

Answers

1. A company incorporated under the Companies Act, 2013 or under any previous company law
2. An artificial person
3. Perpetual succession.
4. ‘Com’ meaning ‘with’ or ‘together’ and ‘panis’ meaning ‘bread’.
5. Chartered Company.
6. 200
7. 7
8. Prof. L .H. Haney
9. Company limited by shares
10. Unlimited liability company

Self-Assessment Questions

◊ Explain the different classifications of companies based on ownership.

◊ What are the key distinctions between a Public Company and a Private Company?

◊ Define a company as per Section 2(20) of the Companies Act, 2013.

◊ What is meant by ‘perpetual succession’ in the context of a company?

◊ List the three ways in which companies may be incorporated.

◊ What distinguishes a ‘Chartered Company’ from a ‘Statutory Company’?

◊ Explain the liability of members in a company limited by shares.

◊ What are the key characteristics of a Private Company as per Section 2(68) of the Companies Act, 2013?

Assignments

1. Evaluate the reasons for the emergence of the concept of a company as a business organization. What challenges in other forms of business led to the development of the corporate form?
2. Discuss the importance of the 'Register of Members' and 'Index of Members' for a company. How do these records contribute to the company's legal and administrative processes?
3. Illustrate the differences between a company limited by shares and a company limited by guarantee. Provide examples of situations where each type of company might be preferred.
4. Examine the role of a company's Board of Directors. How is the concept of 'ownership divorced from management' implemented in a joint-stock company?

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Unit 2 Preparation of Final Accounts

Learning Outcomes

After completing this unit, the learner will be able to:

- ◊ identify and categorise assets and liabilities into non-current and current sections
- ◊ develop the ability to prepare a balance sheet using the provided financial data
- ◊ recognize the key components of a Profit and Loss Account, including revenue, expenses, and profit calculation
- ◊ prepare a Profit and Loss Account from the given financial data, including the calculation of profit or loss for a given period

Prerequisite

Assume a well-established company called Crystal Pure Beverages Ltd., which has just completed another busy financial year. The directors are eager to know how well the company has performed, how much profit it has earned, and what its financial position looks like. To get a clear and reliable picture, the company must prepare its final accounts. The accountants begin by preparing the Profit and Loss Account, which shows all the incomes and expenses of the year and reveals whether the company made a profit or suffered a loss. Next, they prepare the Balance Sheet, a structured statement showing the company's assets, liabilities, and shareholders' funds on the last day of the year. They follow the prescribed forms and contents required by law, ensuring that ever y item from share capital to fixed assets, reserves, loans, and current liabilities is presented correctly. Through this annual process, Crystal Pure understands its financial health and reports it to shareholders with transparency. This simple journey helps learners see why final accounts are essential, how they are prepared, and what details must appear in the Profit and Loss Account and Balance Sheet of a company.

Keywords

Balance sheet, Profit and Loss account, Non-current assets and liabilities, Current assets and liabilities

Discussion

3.2.1 Final Accounts

Final accounts, also called financial statements are organised compilations of financial data, systematically gathered and categorised according to accounting principles, to evaluate an enterprise's financial standing in terms of profitability, operational efficiency, short-term and long-term solvency, and growth potential. They serve as the primary and formal method by which a company's management communicates financial information, along with specific quantitative details, to the public.

These statements are structured representations of an enterprise's financial position, performance, and cash flows, and are relied upon by many users as a key source of financial information. As such, financial statements must be prepared and presented to meet the needs of these users, who generally depend on them for making informed economic decisions. Although certain users may have the ability to request additional information beyond what is presented in the financial statements, this does not diminish the importance of the financial statements for the general user. Financial statements provide crucial information that reflects the results of management's stewardship and accountability for the resources entrusted to them. The main components of a company's consolidated financial statements include Balance Sheet, Statement of Profit and Loss account, Cash flow statement, Statement of changes in equity, and Annexures. The present unit focus only on Balance Sheet and Statement of Profit and Loss.

The following are the key terms to be understood while preparing the final accounts of a company:

i. Non-Current Assets :It includes long-term resources owned by the company that are not expected to be converted into cash within the next year. This includes Property, Plant & Equipment (PPE), Intangible Assets (like goodwill and patents), Investment Property, and Capital Work in Progress.

ii. Current Assets : It includes the short-term assets that are expected to be converted into cash or consumed within the business cycle, usually one year. Examples include Inventories, Trade Receivables, Cash and Cash Equivalents, and Current Tax Assets.

iii. Non-Current Liabilities :It includes long-term financial obligations that are not due within the next year, such as Long-term Borrowings, Deferred Tax Liabilities, and Provisions for Contingencies.

iv. Current Liabilities :It includes the obligations that the company is expected to settle within the business cycle, usually within a year. This includes Short-term Borrowings, Trade Payables, and Current Tax Liabilities.

v. Share Capital : The amount invested by the shareholders in the company is called the share capital. It is divided into Equity Share Capital (common stock) and Other Share Capital.

vi. Reserves and Surplus : It includes the accumulated profits that have not been distributed to shareholders as dividends. This may include General Reserves, Capital Reserves, and Retained Earnings.

vii. Revenue from Operations : It includes the income earned from the core business activities of the company, such as sales of goods and services.

viii. Other Income : It includes the income earned from non-core business activities, such as interest received, dividends, and rental income.

ix. Profit Before Tax (PBT) : The profit earned by the company before deducting income tax. It is calculated by subtracting total expenses from total revenue.

x. Profit After Tax (PAT) : The profit available after the company has accounted for all taxes.

xi. Earnings Per Share (EPS) : It is a measure of the profitability of a company, calculated as the net profit attributable to equity shareholders divided by the number of equity shares outstanding.

$$EPS = \frac{\text{Profit available to equity share holders}}{\text{No.of equity shares}}$$

xii. Depreciation and Amortization : Depreciation is the systematic allocation of the cost of a tangible asset over its useful life.Amortization is the systematic allocation of the cost of an intangible asset over its useful life.

xiii. Provisions-Provision are liabilities of uncertain timing or amount. Companies must make provisions for anticipated liabilities or losses, such as Provision for Bad Debts or Provision for Depreciation.

xiv. Contingent Liabilities : Contingent liabilities are potential obligations that may arise depending on the outcome of a future event. These are not recognised in the balance sheet but disclosed in the notes to accounts.

xv. Deferred Tax-Deferred tax refers to a difference between the tax expenses recognised in the financial statements and the amount of tax payable to the tax authorities. This difference arises due to the timing differences between how income and expenses are recognised for accounting purposes and how they are recognised for tax purposes.

NEW FORMAT OF VERTICAL BALANCE SHEET (WITH MAJOR HEADINGS AND SUBHEADINGS) Balance sheet ………….

Name of Company.........

Balance Sheet as at......... (Rupees in…)

	Particulars	Figures as at end of the current reporting period.	Figures as at end of the previous reporting period.
I	EQUITY AND LIABILITIES		
(1)	Shareholders' funds		
	(a) share capital	xxx	xxx
	(b) Reserves and surplus	xxx	xxx
	(c) money received against share warrants	xxx	xxx
(2)	Share application money pending allotment	xxx	xxx
(3)	Non-current liabilities		
	(i) Long term Borrowings	xxx	xxx
	(ii) Deferred tax liabilities (net)	xxx	xxx
	(iii) Other long termLiabilities	xxx	xxx
	(iv) Long term provisions	xxx	xxx
(4)	Current Liabilities		
	(i) short term Borrowings	xxx	xxx
	(ii) Trade payables	xxx	xxx
	(iii) other current liabilities	xxx	xxx
	(iv) short term provisions	xxx	xxx
	Total (1+2+3+4)	xxx	xxx
II	ASSETS		
(1)	Non –current assets		
	(a) Fixed assets	xxx	xxx
	(i) Tangible assets	xxx	xxx
	(ii) Intangible assets	xxx	xxx
	(iii) Capital work in progress	xxx	xxx
	(b) Non- current investments	xxx	xxx
	(c) Deferred tax assets (Net)	xxx	xxx
	(d) Long term loans and advances	xxx	xxx
	(e) Other non –current assets	xxx	xxx
(2)	Current assets		
	(a)Current investments	xxx	xxx
	(b)Inventories	xxx	xxx
	(c) Trade receivables	xxx	xxx

	(d) Cash and cash equivalents	xxx	xxx
	(e)Short term loans and advances	xxx	xxx
	(f) Other current assets	xxx	xxx
	Total(1+2)	xxx	xxx

Illustration 1

From the following information, prepare the balance sheet of ABC Ltd. as on 31 March 2021 as per Schedule III of Companies Act

Particulars	₹
Advances to employees	3,00,000
Cash at Bank	3,14,320
Furniture	7,50,000
Premises	39,09,940
Patents	10,00,000
Discount on issue of shares	25,000
Trade receivables	3,66,240
Advance tax	50,000
8% Govt bonds	3,36,000
Stock in trade	3,55,600
Equity sharecapital	50,00,000
Capital reserve	60,000
Loan from SBI	8,00,000
Provisions for Employees welfare Fund	6,00,000
Proposed dividend	1,64,000
Short term loan from bank	4,90,200
Unpaid dividend	64,800
Profit and loss A/c	42,980
Bills payable	85,100
Sundry creditors	1,00,020

Solution:

Balance sheet of ABC Ltd as on 31 March 2021

	Particulars	No:	₹
I	EQUITY AND LIABILITIES		
1.	Shareholders' funds		
	(a) Share capital		50,00,000
	(b) Reserves and surplus	1	1,02,980
(2)	Share application money pending allotment		Nil
(3)	Non-current liabilities		
	i Long term Borrowings		8,00,000
	ii Long term provisions		6,00,000
(4)	Current Liabilities		
	i short term Borrowings		4,90,200
	ii Trade payables	2	1,85,120
	iii Other current liabilities		64,800
	iv short term provisions		1,64,000
	TOTAL		74,07,100
II	ASSETS		
1.	Non - Current assts		
	(a) Fixed assts		
	(1) Tangible Assets	3	46,59,940
	Intangible assets		10,00,000
	Other non- current assets		25,000
2.	Current assets		
	(a) Current investments		3,36,000
	(b) Inventories		3,55,600
	(c) Trade receivables		3,66,240
	(d) Cash and cash equivalents		3,14,320
	(e) Short term loans and advances		3,00,000
	(f) Other current assets		50,000
	TOTAL		74,07,100

Notes to the financial statement-

1. Reserve and surplus

Capital reserve	=	60, 000
Profit & Loss A/C (Cr balance)	=	42, 980
Total	**=**	**1, 02, 980**

2. Trade Payables

Sundry creditors	=	1, 00, 020
Bills payable	=	85, 100
Total	**=**	**1, 85, 120**

3. **Tangible fixed assets**

Premises	= 39, 09, 940
Furniture and Fixtures	= 7, 50, 000
Total	**= 46, 59, 940**

3.2.2 Profit and Loss Account

The profit or loss incurred by a company during a particular period is reflected in the Statement of Profit and Loss of a company. It provides a detailed summary of a company's revenues, expenses, and profits or losses over a specific period. It also depicts the Earnings Per Share (EPS) of the company, which is classified into Basic EPS and Diluted EPS. Basic EPS is calculated using the net profit available to common shareholders divided by the weighted average number of common shares outstanding during the period. Diluted EPS accounts for all potential shares that could be created from convertible securities, stock options, and other financial instruments that may dilute the earnings per share.The format and content of the Profit and loss account are governed by Part II of Schedule III of the Companies Act, 2013. The following table shows the format of the Statement of profit or loss of a company:

Format of Statement of Profit and Loss

Name of the Company......

Profit and Loss Statement for the year ended..... (Repay in.......

Particulars	Note No.	Figures for the current reporting period	Figures for the previous reporting period
I. Revenue from operations		xxx	xxx
II. Other income		xxx	xxx
III. Total Revenue (1+2)		xxx	xxx
IV. Expenses:		xxx	xxx
Cost of material consumed			
Purchase of stock in trade			
Changes in inventories of finished goods			
Work-in-progress and Stock in trade			
Employee benefit expense			
Finance costs			
Depreciation and amortization expense			
Other expenses			
Total expenses			
V. Profit before exceptional and extraordinary items and tax (iii - iv)		xxx	xxx
VI. Exceptional items		xxx	xxx

VII. Profit before extraordinary items and tax(v - vi)		xxx	xxx
VIII. Extraordinary items		xxx	xxx
IX. Profit before tax(vii - viii)		xxx	xxx
X. Tax expenses:		xxx	xxx
a) Current tax		xxx	xxx
b) Deferred tax		xxx	xxx
XI. Profit (loss) for the period from continuing operations (ix-x)		xxx	xxx
XII. Profit (loss) from discontinuing operations		xxx	xxx
XIII. Tax expense of discontinuing operations		xxx	xxx
XIV. Profit /Loss from discontinuing operations (after tax)(xii – xiii)		xxx	xxx
XV. Profit (Loss) for the period (xi + xiv)		xxx	xxx
XVI. Earning per equity share:		xxx	xxx
a) Basic		xxx	xxx
b) Diluted		xxx	xxx

Illustration 2

From the following figures relating to XYZ Ltd. for the year ended 31 March 2020, prepare a statement of profit or loss along with the accompanying notes.

Sales		15,50,000
Equity share capital		8,00,000
Outstanding wages		6,000
Premises		1,60,000
P.F contribution		86,000
Machinery		6,00,000
Tax expense for the year	60, 000	
Sales return		50,000
Rent	40, 200	
Depreciation on machinery		18,000
Interest on loan		16,000
Bonus to employees		20,000
Bad debts		3,800
Salaries		1,14,000
Opening stock		40,000

Materials consumed		8,00,000
Depreciation on premises		8,000
Closing stock		1,20,000

Solution

XYZ Ltd

Statement of Profit and loss as on 31st March 2020

	Notes No.	Figures for year ending 31-3-2020
(i) Revenue from operations	1	15,00,000
(ii) Other income –		nil
(iii) Total revenue		15,00,000
(iv) Expenses		
a) Cost of material consumed		8,00,000
b) Purchase of stock in trade		0
c) Changes in inventories	2	
(Closing stock – opening stock)		(80,000)
d) Employee benefit expense	3	2,26,000
e) Finance cost		16,000
f) Depreciation and amortization	4	26,000
g) Other expense	5	44,000
Total expenses		10,92,000
Profit before exceptional and extraordinary items and tax (iii - iv)		3, 08,000
Exceptional items		-
Profit before extraordinary items and tax		3,08 000
Extraordinary items		-
Profit before tax		3,08,000
Tax expenses for the current year		(60,000)
Profit (loss) for the period from continuing operations		24,8,000
Profit (loss) from discontinuing operations		nil
Tax expense of discontinuing operations		-
Profit /Loss from discontinuing operations (after tax)		-
Profit (Loss) for the period		2,48,000
Earning per equity share:		
a) Basic		-
b) Diluted		-

Notes:Forming part of the statement of Profit & Loss

1. Revenue from operation

Sales	15, 50, 000
Less sales return	50, 000
Net sales	**15, 00, 000**

2. Change in inventories

Closing stock	(1, 20, 000)
Less Opening stock	40, 000
Total	**(80, 000)**

3. Employee benefit expense

Salaries	1, 14, 000
PF contribution	86, 000
Bonus to employees	20, 000
Out standing wages	6000
Total	**2, 26, 000**

4. Depreciation and amortization

Depreciation on premises	8, 000
Depreciation on machinery	18, 000
Total	**26, 000**

5. Other expense

Rent	40, 200
Bad debts	3, 800
Total	**44, 000**

In the given question, the face value per share is not given. Hence EPS is not calculated.

Recap

- ◊ Final accounts depict the financial position and the profit or loss of a company for a particular accounting period.
- ◊ Components of consolidated financial statements include the balance sheet, statement of profit and loss, cash flow statement, statement of changes in equity, and related annexures.
- ◊ Non current assets are long term assets that are held by a company for use over more than one accounting period.
- ◊ Current assets are short term assets that are expected to be converted into cash within one year or within the operating cycle.
- ◊ Revenue from operations refers to income earned from the core business activities of a company.

- Contingent liabilities are potential obligations that depend on the occurrence or non occurrence of future events and are disclosed in the notes to accounts.
- Deferred tax refers to the tax effect arising due to timing differences between accounting income and taxable income.
- Earnings per share is a measure of profitability that shows the amount of profit attributable to each equity share and may be calculated as basic or diluted earnings per share.
- The balance sheet depicts the financial position of a company as on a specific date.
- The profit and loss account shows the revenues earned, expenses incurred, and profit or loss of a company during a specific period.

Objective Questions

1. What is the term for long-term resources not expected to be converted into cash within the next year?
2. Which term refers to short-term assets expected to be converted into cash within one year?
3. What are long-term financial obligations that are not due within the next year called?
4. What is the term for obligations expected to be settled within the business cycle, usually within a year?
5. What is the amount invested by shareholders in the company known as?
6. What refers to income earned from core business activities?
7. What is the profit available after accounting for all taxes?
8. What measures profitability and is calculated as net profit divided by the number of equity shares outstanding?
9. What are potential obligations that may arise depending on the outcome of a future event called?
10. What refers to the difference between tax expenses recognised in financial statements and the amount payable to tax authorities?
11. Which statement provides a detailed summary of a company's revenues, expenses, and profits or losses over a specific period?
12. Which financial statement depicts the financial position of a company as of a specific date?

Answers

1. Non-Current Assets
2. Current Assets
3. Non-Current Liabilities
4. Current Liabilities
5. Share Capital
6. Revenue from Operations
7. Profit After Tax (PAT)
8. Earnings Per Share (EPS)Contingent Liabilities
9. Contingent Liabilities
10. Deferred Tax
11. Statement of Profit and Loss
12. Balance Sheet

Self Assessment Questions

◊ What are non-current assets? Provide two examples.

◊ What is the difference between Profit Before Tax (PBT) and Profit After Tax (PAT)?

◊ How is Earnings Per Share (EPS) calculated?

◊ Explain the preparation and presentation of the Balance Sheet and Profit and Loss Account as per Schedule III of the Companies Act, 2013. Discuss the key elements that must be included in these statements.

◊ Critically assess the importance of Earnings Per Share (EPS) as a performance metric. Compare Basic EPS and Diluted EPS, and explain their relevance to investors.

◊ Differentiate between Depreciation and Amortization.

◊ Explain the term 'Current Liabilities' with an example.

◊ What are contingent liabilities and how are they disclosed in financial statements of a company?

Assignments

1. From the following particulars presented by Thilak for the year ended 31st March, 2017, prepare profit and loss account.

Particulars	₹	Particulars	₹
Gross profit	1,00,000	Interest received	6,000
Rent paid	22,000	Bad debts	2,000
Salaries	10,000	Provision for bad debts (1-4-2016)	4,000
Commission (Cr.)	12,000	Sundry debtors	40,000
Discount received	2,000	Buildings	80,000
Insurance premium paid	8,000		

Adjustments:

i. Outstanding salaries amounted to Rs. 4, 000

ii. Rent paid for 11 months

iii. Interest due but not received amounted to Rs. 2, 000

iv. Prepaid insurance amounted to Rs. 2, 000

v. Depreciate buildings by 10%

vi. Further bad debts amounted to Rs. 3, 000 and make a provision for bad debts @ 5% on sundry debtors

vii. Commission received in advance amounted to Rs. 2, 000

(ANSWER – Net profit =65100)

2. Analyse the significance of 'perpetual succession' and 'common seal' in the context of a company's operations and legal standing.

3. From the following particulars, prepare the balance sheet of Madhu, for the year ended 31st March, 2018.

Particulars	₹	Particulars	₹
Capital	2,00,000	Sundry creditors	40,000
Drawings	40,000	Bills payable	20,000
Cash in hand	15,000	Goodwill	60,000
Loan from bank	40,000	Sundry debtors	80,000
Bank overdraft	20,000	Land and building	50,000
Investments	20,000	Vehicles	80,000
Bills receivable	10,000	Cash at bank	25,000

The following adjustments were made at the time of preparing final accounts:

i. Outstanding liabilities: Salaries Rs. 10,000,Wages- Rs.20,000,Interest on Bank Over draft + Rs 3000 and Interest on bank loan Rs. Rs. 6000

ii. Provide interest on capital @ 10% p.a.

iii. Bad debts amounted to Rs. 10,000 and make provision for Bad debts@ 10% on Sundry debtors.

iv. Closing stock amounted to Rs. 1,20,000.

v. Depreciate vehicles @ 10% p.a.

Net profit for the year amounted to Rs. 96,000 after considering all the above adjustments.

Ans: Balance Sheet. Total: Rs. 435000.

4. Explore the concept of 'Government Companies' and 'Foreign Companies'. How do these differ from other types of companies, and what unique challenges do they face in terms of regulation and compliance?

5. . The following balances were extracted from the books of Thomas as on 31st March, 2018

Particulars	₹	Particulars	₹
Purchases	75,000	Capital	60,000
Returns inward	2,000	Creditors	30,000
Opening stock	10,000	Sales	1,20,000
Freight inwards	4,000	Returns outward	1,000
Wages	2,000		
Investments	10,000		
Bank charges	1,000		
Land	30,000		
Machinery	30,000		
Building	25,000		
Cash at bank	18,000		
Cash in hand	4,000		
	2,11,000		2,11,000

Additional information:

i. Closing stock Rs. 9, 000

ii. Provide depreciation @ 10% on machinery

iii. Interest accrued on investment Rs. 2, 000

Prepare trading account, Profit and Loss Account and Balance Sheet

(Answers – Net profit 35000, Balance sheet total Rs.1,25,000)

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4

BLOCK

Auditing

Unit 1 Basic Concepts of Auditing

Learning Outcomes

After completing this unit, the learner will be able to:

- ◊ describe the nature and objectives of auditing
- ◊ differentiate audit and investigation
- ◊ explain different types of audits
- ◊ identify the qualities and legal provisions required for auditor appointment

Prerequisite

Kaveri Ltd, a busy cashew-processing factory, the accounts manager Meera noticed unusual delays in supplier payments. Concerned, she invited an experienced auditor, Mr Arav, to review the records. When he arrived, his calm questions and sharp observation immediately changed the atmosphere. As he examined the ledgers, everyone felt curious and a little tense what would he uncover? Within a few hours, he traced the problem to simple clerical mistakes rather than fraud, and the entire factory staff sighed with relief. Watching him work with confidence and integrity, Meera realised how important auditing is in keeping a business honest, transparent, and well-managed. This small incident sparked her interest and made her eager to learn more about the world of auditing.

Keywords

Auditing, Nature, Scope, Features, Objectives, Types of audits

Discussion

Kaveri Ltd.'s cashew factory, the owner, Mr Ravi, noticed that although production was increasing, the profits didn't match the growth. Curious and slightly worried, he called young accountant Renu to check the books. Renu, unsure of where the problem might be, suggested bringing in an auditor. The next day, Ms Shalini, an experienced auditor, arrived. She calmly reviewed invoices, checked stock records, and compared accounts with actual production figures. Within a short time, she identified small recording errors that had added up over months. Everyone was surprised at how quickly she understood the situation. Watching her work, Renu realised that auditing simply means examining records carefully to ensure everything is correct and trustworthy. That day, she understood why every business needs auditing to stay accurate, transparent, and confident in its own numbers.

4.1.1 Meaning of Auditing

Auditing was instigated from the Latin word "audire". In ancient days, the person responsible for maintaining accounts has gotten it certified as correct by an independent person. For this purpose, he has to explain the details of accounts before an expert and the expert heard it carefully and certifies the correctness of the accounts. The person hearing the details of accounts is called Auditor. That is why the term auditing originated from the term audire which means to hear. Auditing is a critical examination of books of accounts and other documents of a business so as to assure the accuracy and authenticity of books of accounts. Auditing is basically related to the inspection of books of accounts which is prepared by the accountant. It is done by an outsider usually at the end of the accounting year or periodically. It is an intelligent and critical test of the accuracy, adequacy, and dependability of accounting data and accounting statements. It is an examination of accounts to ascertain whether the financial statements give a true and fair view financial position and profit or loss of the business.

4.1.2 Definition of Auditing

As per the General Guidelines on Internal Auditing issued by ICAI, "auditing is defined as a systematic and independent examination of data, statements, records, operations and performances (financial or otherwise) of an enterprise for a stated purpose. In any auditing situation, the auditor perceives and recognizes the propositions before him for examination, collects evidence, evaluates the same and on this basis formulates his judgment which is communicated through his audit report.

Spicer and Pegler, defined auditing as, "Auditing is such an examination of 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 affairs of the business and whether the profit and loss account gives a true and fair view of the profit or loss of the financial period, according to the best of the information and explanation given to him and as shown by the books, and if not, in what respect he is not satisfied."

The analysis of the above definitions makes it clear that auditing is the process of examining the accuracy and authenticity of books of accounts with the help of supporting documents and making sure that books of accounts show a correct picture of the state of affairs of the business.

4.1.3 Scope of Auditing

Auditing is basically connected to the examination of books of accounts to test their authenticity and accuracy. The depth and width of auditing depend on the need. For example, if fraud is suspected, all cash transactions should be examined. Due to the immensity of transactions, the auditor cannot check all transactions, but he can adopt test checking if there is an effective internal check system in force. In recent years, the scope of audits has increased. It is related to the examination of books of account, evidence, bills, stock, and its physical verification, etc. An auditor not only check the books of account on the basis of evidence but also has to check the authenticity of doc uments. In short, the scope of audit covers the checking of books of accounts, valuation and physical verification of assets and liabilities, and checking of available evidence. Moreover, the legal requirements also decide the scope of the audit.

4.1.4 Nature of Auditing

Auditing plays a vital role in ensuring that a business's financial records are correct and trustworthy. For example, in a cashew factory like Kaveri Ltd, hundreds of transactions take place every day purchase of raw nuts, payment of wages, sales to buyers, and many more. If even a few entries are recorded wrongly, the entire financial picture can become misleading. Auditing helps prevent such problems by carefully examining all records and supporting documents. The following features explain what makes auditing a reliable and essential process for every organisation.

◊ Systematic Examination : Auditing involves a planned and organised review of the books of accounts and related documents of a business organisation.

◊ Verification of Authenticity : The auditor checks the truthfulness of transactions using supporting documents such as vouchers, bills, receipts, carbon copies, and counterfoils.

◊ Independent Examination : An audit is conducted by an independent person or a group of qualified professionals to ensure unbiased reporting.

◊ No Responsibility for Preparing Accounts : The auditor does not prepare the books of accounts; these are usually prepared by accountants or other staff of the organisation.

◊ Qualification Requirement : In businesses where auditing is compulsory, the auditor must be a qualified Chartered Accountant.

◊ Wide Scope : The scope of auditing includes not only checking commercial transactions but may extend to non-commercial matters, especially during investigations.

◊ Certification of Accuracy : The auditor must satisfy himself and certify the accuracy and authenticity of the Profit and Loss Account and the Balance Sheet.

◊ Reporting Unsatisfactory Findings : If the auditor is not satisfied with the correctness of the books of accounts, he must clearly state the issue in his audit report.

◊ Critical Review of Systems : Auditing includes a careful and critical examination of the organisation's accounting system and internal control procedures to identify weaknesses or irregularities.

◊ Communication of Results : The auditor must communicate the audit findings to the authority that appointed him. For example, in a company, the audit report is submitted to the shareholders.

4.1.5 Objectives of Auditing

After understanding the features of auditing, it becomes important to know *why* auditing is carried out in every business. Auditing is not just about checking books it aims to ensure transparency, protect the organisation's financial health, and build trust among all stakeholders. The following are the major objectives of auditing:

i. Accounts and Statements Verification

The primary objective of auditing is to verify the accuracy and fairness of the books of accounts and financial statements. During an audit, every important financial transaction is checked with supporting documents to ensure that it has been recorded correctly. This systematic verification helps detect and prevent irregularities or fraud, making the financial reports more trustworthy.

ii. Checking Accounting Policies

Every organisation must follow established accounting policies while maintaining its financial records. An audit examines whether these policies have been applied properly and consistently. When the accounting system is followed correctly, it improves the efficiency of the organisation by ensuring that records are clear, reliable, and uniform.

iii. Error and Fraud Detection

Another key objective of auditing is to identify errors, misstatements, or fraudulent activities in the books of accounts. Auditors carefully examine records to detect mistakes that may have occurred intentionally or unintentionally. Early detection helps management take corrective action and strengthens the organisation's financial discipline.

iv. Improves Quality of Business Processes

When the audit process uncovers errors or weaknesses in the accounting system, the management can take timely steps to correct them. This leads to improvement in business processes, better internal control, and increased operational efficiency. Employees also tend to work more carefully and honestly when they know that the accounts will be audited regularly.

v. Assurance to Investors

Investors rely on financial statements to understand the performance and stability of a business. Auditing provides assurance that the figures shown in these statements are accurate and trustworthy. This protects the interests of shareholders, especially because they cannot inspect the company's books personally. Audited accounts help maintain investor confidence and support long-term business growth.

vi. Evaluation of Assets and Liabilities

Auditing also aims to verify the real value of the organisation's assets and liabilities. By examining the financial statements in detail, auditors help confirm whether the values shown are true and fair. This accurate evaluation is important for planning, budgeting, and achieving the business's future goals.

4.1.6 Significance of Auditing

After understanding the objectives of auditing such as verifying accounts, detecting errors and fraud, checking compliance with accounting policies, and assuring investors it is equally important to recognise why these objectives matter in real business practice. The significance of auditing explains how these objectives support transparency, strengthen internal control, protect stakeholders, and improve overall business efficiency. The following points highlight the major areas where auditing plays a vital role in an organisation.

i. Protection of Stakeholders' Interests

Many stakeholders such as shareholders, creditors, bankers, and partners depend on financial statements but may not have specialised financial knowledge. They trust the independence and impartiality of the auditor. A proper audit helps protect their interests by assuring them that the accounts present a true and fair view.

ii. Enhances Credibility of Financial Statements

The reliability of financial statements increases when they carry an auditor's certificate. Since only qualified professionals are appointed as auditors, stakeholders can depend on the audited statements while making decisions. Auditing therefore strengthens trust in the organisation's financial reporting.

iii. Prevention and Detection of Fraud

Internal auditing involves continuous examination of company operations and internal controls. This regular checking helps prevent fraudulent activities from occurring and enables early detection of any irregularities.

iv. Identification of Risks and Performance Weaknesses

Auditors assess the risk of material misstatements and analyse financial information to identify which products, units, or divisions are performing well and which need managerial attention. This helps management take informed decisions.

v. Reduction of Misstatements and Business Risks

Auditing presents the true status of assets and liabilities by reducing errors, misstatements, and manipulation in company records. A strong audit mechanism decreases the risks related to fraud, misappropriation of assets, poor information flow, and management underperformance.

vi. Strengthening Internal Control Systems

An effective audit system ensures that internal controls are properly implemented and followed within the organisation. This increases financial discipline and operational efficiency.

vii. Encourages Proper Maintenance of Records

Auditing motivates the organisation to maintain accurate and complete business records at all times. Proper record-keeping, in turn, improves the overall productivity of the business.

viii. Continuous Review and Improvement of Internal Controls

Internal auditors frequently examine the internal control structure, recommend improvements, and report any weaknesses to the appropriate management level. This leads to continuous strengthening of the organisation's systems.

ix. Ensuring Auditor Independence and Objectivity

The significance of auditing lies in its objectivity. The auditor must remain completely independent and free from any influence that could affect professional judgement. This independence ensures fair and unbiased reporting.

x. Prevention of Fraud Through Strong Control Environment

Audit professionals help design a robust internal control system that discourages fraud. When employees know that strong audits are in place, they tend to act more responsibly. A good audit reputation alone can deter employees or vendors from attempting fraudulent activities.

xi. Helpful in Settling Various Financial Matters

Auditing is essential for resolving tax liabilities, obtaining tax refunds, settling trade disputes, distributing accounts at the time of a partner's retirement or death, and during company liquidation. It provides accurate information needed for such situations.

xii. Requirement for Government Assistance and Grants

Audited financial statements are compulsory for receiving government grants, subsidies, or assistance. They serve as proof of reliability and financial discipline.

4.1.7 scope of auditing

After understanding the objectives and significance of auditing, it is important to know the extent and areas covered by auditing. The scope of auditing defines how broadly an auditor examines an organisation's financial and operational activities to ensure accuracy, transparency, and compliance. Essentially, auditing is not limited to just checking the accounts; it also involves evaluating internal controls, procedures, and other non-financial aspects that affect the financial position of a business. For example, in a cashew-processing company like Kaveri Ltd, an auditor may check not only the purchase and sales transactions but also verify stock records, machinery maintenance logs, wage payments, and adherence to quality control procedures.

The scope of auditing typically includes the following areas:

i. Verification of Financial Records:

The auditor examines all books of accounts, vouchers, bills, receipts, and other documents to ensure that all financial transactions are recorded accurately and completely. For instance, in Kaveri Ltd, purchase records for raw cashews and sales invoices to wholesalers are checked for correctness.

ii. Examination of Internal Control Systems:

Auditors review the company's internal control mechanisms, such as authorisation procedures, segregation of duties, and stock management controls, to ensure they are functioning effectively and reducing the risk of fraud or errors.

iii. Evaluation of Assets and Liabilities:

The auditor assesses whether assets like machinery, raw materials, and cash are properly valued and recorded, and whether liabilities such as loans, wages, and pending payments are correctly accounted for. In a cashew factory, this may include verifying stored raw nuts and finished goods inventories.

iv. Compliance with Accounting Policies and Legal Requirements:

Auditing checks that the organisation follows approved accounting principles, corporate laws, tax regulations, and industry-specific standards. For example, ensuring Kaveri Ltd complies with statutory deductions on wages or GST rules for sales.

v. Detection of Errors and Frauds:

Auditors examine records to detect mistakes, omissions, or fraudulent activities. Continuous monitoring and evaluation help prevent losses and enable management to take corrective actions promptly.

vi. Reporting and Recommendations:

The auditor communicates findings to management or stakeholders, highlights areas of concern, and may suggest improvements in processes or internal controls to enhance operational efficiency and financial reliability.

In Kaveri Ltd, the auditor not only checks whether all raw cashew purchases and sales are recorded correctly but also reviews whether the factory's weighing machines are calibrated, whether wages are paid correctly, and whether quality control records match actual production. This shows that auditing covers both financial and operational aspects, making it an essential tool for management and stakeholders alike.

4.1.8 Auditor

After understanding the scope of auditing, it is important to know who conducts the audit and what their responsibilities are. The person assigned to carry out an audit is called an auditor. Auditors are professionally qualified individuals, appointed to examine an organisation's financial statements and ensure that they give a true and fair view of the company's financial position and performance. For example, in a cashew-processing factory like Kaveri Ltd, the auditor checks whether the profit and loss account accurately reflects the earnings from sales and whether the balance sheet correctly shows the value of raw nuts, machinery, and other assets.

The auditor also ensures that the accounts comply with all legal requirements. If any discrepancies, errors, or areas of concern are found, the auditor highlights them in the audit report. This report is then submitted to the management or stakeholders, providing them with confidence in the reliability of the financial statements.

Qualities of an Auditor

A good auditor must possess several important qualities to perform their duties effectively:

- ◊ **Integrity, Objectivity, and Independence:** The auditor must remain honest, impartial, and independent throughout the audit process.
- ◊ **Honesty and Professional Care:** Auditors should exercise reasonable care and skill, ensuring that any certification of accounts is accurate and reliable.
- ◊ **Knowledge of Legal Framework:** They must be familiar with the laws and regulations applicable to the entity being audited.
- ◊ **Technical Competence:** Auditors should have a strong understanding of auditing, accounting, economics, and mathematics to evaluate complex financial data.
- ◊ **Industry Awareness:** Understanding the unique characteristics of the specific industry they are auditing helps auditors provide more accurate and relevant assessments.

4.1.8.1 Appointment of Auditor Under the Companies Act, 2013

Appointment of auditors in a company is governed by Section 139 of the Companies Act, 2013 and related rules framed under the Act. These provisions ensure that auditors are appointed in a transparent, fair, and legally compliant manner so that financial statements can be independently audited and trusted by stakeholders.

i. Appointment at the First Annual General Meeting (AGM)

Under Section 139(1), every company (except government companies) must appoint an individual or a firm as its auditor at the first AGM after incorporation. The appointed auditor will hold office from the conclusion of that meeting until the conclusion of the sixth annual general meeting. The procedure for selection and appointment is prescribed by the Act and rules made thereunder.

Before the appointment, the company must obtain the auditor's written consent and a certificate stating that the auditor, if appointed, satisfies the conditions laid down in the Act and rules. The certificate must also confirm that the auditor meets the eligibility criteria of Section 141 (which deals with qualifications and disqualifications). After appointment, the company must inform the auditor of his or her appointment and file a notice with the Registrar of Companies (ROC) in the prescribed form (currently Form ADT-1) within 15 days of the meeting.

ii. Appointment of the First Auditor

Section 139(6) covers the first auditor of a newly incorporated company. For companies other than government companies:

◊ The Board of Directors must appoint the first auditor within 30 days of incorporation.

◊ If the Board fails to do so, the members must appoint the first auditor within 90 days at an Extraordinary General Meeting (EGM).

◊ The first auditor will hold office until the first AGM.

This ensures that there is no gap in audit coverage even before the first AGM.

iii. Term and Rotation of Auditors

Once appointed at the first AGM, the auditor continues in office until the sixth AGM. However, specific classes of companies (such as listed companies and certain large unlisted companies) must follow rotation rules under Section 139(2). These rules state that:

◊ An individual auditor cannot be appointed or re-appointed for more than one term of five consecutive years.

◊ An audit firm cannot be appointed or re-appointed for more than two terms of five consecutive years (total ten years).

◊ After completing such terms, neither the individual nor the firm can be reappointed in the same company for five years as a cooling-off period.

◊ Additionally, no audit firm having a common partner with the outgoing auditor can be appointed for the next five years to ensure independence.

These provisions have been introduced to maintain auditor independence and reduce the risk of overly long associations between auditors and audit clients.

iv. Special Provisions for Government Companies

In the case of a government company, the Comptroller and Auditor-General of India (CAG) appoint the statutory auditor within 180 days of the start of a financial year. The appointed auditor holds office until the next AGM. If the CAG does not appoint the auditor within the specified period, the Board of Directors may appoint one, and in case of default, the members may do so through an EGM.

v. Filling Casual Vacancies

If the position of auditor falls vacant before the end of the term (for example, due to resignation or removal), the Board of Directors must fill the vacancy within 30 days. If the company's accounts are normally audited by an auditor appointed by the CAG, then the CAG fills the vacancy within 30 days. If the CAG fails to do so, the Board can fill the vacancy.

vi. Re-appointment and Continuance

Under Section 139(9), a retiring auditor may be re-appointed if:

They are not disqualified for re-appointment.

They have not expressed unwillingness in writing.

No special resolution has been passed to appoint a different auditor.

If no auditor is appointed at an AGM, the existing auditor continues in office until the next meeting as per Section 139(10)

Suppose Kaveri Ltd holds its first AGM on 30th March 2026. It must appoint its statutory auditor at this meeting (Section 139(1)). The appointed auditor will serve until the conclusion of the 6th AGM (i.e., five years) unless disqualified or removed. Before appointment, the auditor must provide written consent and a certificate confirming eligibility and compliance with Section 141. The company must then file Form ADT-1 with the ROC within 15 days of the appointment. In the case of large companies, rotation rules may limit how long the same auditor can continue.

4.1.9 Audit and Investigation

Auditing and investigation are both methods of examining a company's financial records, but they differ in purpose, scope, and approach. While auditing is a regular and systematic check of accounts to ensure correctness and fairness, investigation is usually conducted for a specific purpose, such as verifying the accounts of a prospective partner, detecting fraud, or evaluating financial irregularities. For example, in a cashew-processing company like Kaveri Ltd, an auditor might review the yearly accounts to provide assurance to shareholders, while an investigator may be hired to check why a particular batch of raw cashews was lost or why payments to a supplier were unusually high. Understanding the difference between auditing and investigation helps students and professionals apply the right approach depending on the business requirement.

Table 4.1.1 Audit and Investigation

Basis	Auditing	Investigation
Concept	An independent and systematic examination of accounting records or other data according to generally accepted auditing practices to ascertain the true and fair view of the financial statements.	An examination of accounts and records aimed at ascertaining specific facts for a special purpose, which varies with each assignment.
Scope	Broader scope; verifies accounts and records for overall truth and fairness.	Narrow scope; focuses on a specific purpose or issue.
Aim / Purpose	To ensure that the financial statements reflect a true and fair view of the business.	To achieve a particular purpose, e.g., verifying information for a prospective partner or detecting fraud.
Procedure	Carried out according to established auditing principles.	Involves extensive procedures tailored to uncover specific information.
Evidence	Based on persuasive evidence enough to make a reasonable person believe in the facts presented.	Based on substantial or conclusive evidence evidence that cannot be easily contradicted.
Approach	Auditors are careful, question entries, but generally assume that records are correct.	Investigators often start with suspicion or a problem in mind and look for proof to confirm or refute it.
Periodicity	Regular, typically conducted annually.	May cover periods longer than a year, depending on the issue under investigation.

4.1.10 Types of Audits

As we have discussed above, auditing is an independent and systematic examination of a company's accounts and records to ensure accuracy, reliability, and compliance with applicable laws and standards. We have also seen the features, scope, and significance of auditing, as well as the role of an auditor in evaluating financial transactions and safeguarding stakeholders' interests. Building on this understanding, it is important to know that audits can be of different types depending on the nature of the organisation, purpose, frequency, and legal requirements. Each type of audit serves a specific objective, such as verifying financial statements, assessing efficiency, or ensuring compliance, and is selected according to the needs of the business or stakeholders.

i. Continuous Audit

This type of audit is conducted by big business organisations where the volume of transactions is large. Here, audit work is done along with the accounting work throughout the accounting year. At the end of the accounting year, majority of the audit work is over. It helps to publish the audited profit/loss account and balance sheet soon after closing the books of accounts at the end of the accounting period. Moreover, a detailed examination of each transaction is possible, because the auditor has more time at his disposal, making this audit more efficient.

The continuous audit is defined by R.C. Williams as: *"A continuous audit is one where the auditor or his staff is constantly engaged in checking the accounts during the whole period or where the auditor or his staff attends at regular or irregular intervals during the period."*

The continuous audit is conducted in the following circumstances:

Where the volume of transactions is large.

- ◊ If there is no satisfactory system of internal check.
- ◊ In case the business requires monthly or quarterly audited financial statements and reports.
- ◊ Where it is necessary to publish audited accounts soon after closing the accounting year.

Advantages:

- ◊ Auditor frequently visits the client and conducts detailed checking; errors and frauds can be easily detected.
- ◊ Client staff remain regular and vigilant due to auditor's frequent visits.
- ◊ Audited accounts can be published quickly.
- ◊ Auditor gains thorough knowledge of the business and can give valuable advice to improve efficiency.
- ◊ Enhances staff morale.
- ◊ Final work of the auditor is reduced as most audit work is done during the year.
- ◊ Interim dividends can be declared easily because audited interim profit is available.

Disadvantages:

- ◊ Frequent visits may interrupt client staff work.
- ◊ More expensive due to continuous effort and higher fees.
- ◊ Audited books may be tampered with by dishonest employees.
- ◊ Close contact with client staff may lead to unethical relationships.
- ◊ Work may become mechanical and monotonous.
- ◊ Audit is not completed in one sitting, reducing curiosity and continuity.

ii. Annual Audit

An annual audit is also called a complete audit, final audit, or periodical audit. This audit is conducted by small concerns. Auditing is done at the end of the financial year after preparing final accounts, namely Profit/Loss Account and Balance Sheet. The audit is completed in a continuous session, where the accounts are handed over to the auditor and returned only after completing the audit work.

Advantages:

- ◊ Client staff work is not interrupted.
- ◊ Smooth workflow as audit is done in one session.
- ◊ Less expensive.
- ◊ Work is not monotonous or mechanical.
- ◊ No chance of collusion between accounting and audit staff.

Disadvantages:

- ◊ Detailed checking is limited.
- ◊ Errors and frauds cannot be completely detected.
- ◊ Not suitable for big concerns.
- ◊ Auditor may rely on management too much.

iii. Interim Audit

An interim audit is conducted between two annual audits. It is done to ascertain interim profit for declaring interim dividends or for fixing share prices and settling partner accounts at the time of admission, retirement, or death.

Advantages:

- ◊ Facilitates completion of the final audit as most work is already done.
- ◊ Promotes moral check on client staff.
- ◊ Helps in easy detection of errors and frauds.

Disadvantages:

- ◊ Figures audited during interim may be altered by staff.
- ◊ Additional work makes it more expensive.
- ◊ Preparation of extensive notes may increase workload.

iv. Statutory Audit

A statutory audit is compulsory as per law or statute. Auditing is not required for all firms. For example, a sole trader with a turnover less than ₹40 lakh is not required to audit accounts. Auditing is compulsory for:

- ◊ Companies registered under the Companies Act, 2013, or previous Companies Acts.
- ◊ Banking companies.

- ◊ Co-operative societies.
- ◊ Electricity supply companies.
- ◊ Corporations set up by central or state government.
- ◊ Registered public charitable trusts.

v. Cash Audit

Cash audit examines all cash transactions using supporting documents such as receipts, counterfoils, vouchers, and correspondence. It ensures accuracy, completeness, and compliance with accounting standards and internal controls. The primary purpose is to verify cash records and detect discrepancies.

vi. Balance Sheet Audit

Balance sheet audit focuses on items in the balance sheet, mainly assets and liabilities. All items are checked in detail. Profit/loss accounts, being part of the balance sheet, may also be checked to ensure accuracy and authenticity.

vii. Cost Audit

Cost audit examines cost accounting records. According to the Institute of Management Accounts, London:

"Cost auditing is the verification of the correctness of cost accounts and adherence to the cost accounting plan."

Smith and Day define it as:

"Detailed checking of costing system, technique, and accounts to verify correctness and adherence to cost accountancy objectives."

A cost audit is independent and provides management with information on reducing production costs, implementing economical production, and improving cost plans

viii. Partial Audit

Partial audit examines specific transactions based on management needs. It is not considered a regular audit and is not accepted where auditing is legally compulsory. It may focus on areas such as payroll, inventory, or sales.

ix. Complete Audit

Complete audit involves checking all transactions thoroughly from beginning to end. Also called full or comprehensive audit, it ensures accuracy, completeness, and compliance with accounting standards and regulations.

x. Management Audit / Efficiency Audit

Management audit evaluates the efficiency of management. According to the American Institute of Management:

"Management audit is a diagnostic appraisal process analysing goals, plans, policies, and activities to uncover weaknesses and develop ideas for improvement."

It focuses on control systems, compliance, and managerial decision-making to assess performance.

xi. Internal Audit

Internal audit is conducted by a company's own staff to critically review records and operations. The internal auditor checks for wastage, weaknesses in internal control, and operational efficiency. The auditor may or may not be a chartered accountant.

xii. Government Audit

Government audit is conducted by the Comptroller and Auditor General of India under Article 149 of the Constitution. It covers government departments and statutory corporations. Chartered accountants may be appointed for government companies. The audit ensures that:

- ◊ Expenditure is authorised.
- ◊ Payments are made to proper persons.
- ◊ Accounts are correctly recorded.
- ◊ Receivables are recovered, and receipts are properly credited.

xiii. Social Audit

Social audit evaluates an organisation's social responsibility and impact on society. Unlike statutory audit, which focuses on financial performance, social audit measures social contribution and ethical behaviour. Simon Zadek defines it as: "Social audit is a means of assessing the social impact and ethical behaviour of an organisation in relation to its aims and stakeholders."

xiv. Tax Audit

Tax audit is conducted for income tax purposes. It examines financial records to ensure correct taxable profit, compliance with Income Tax Act provisions, and fulfilment of deduction conditions.

Recap

- ◊ Auditing is the systematic and independent examination of financial statements and records.
- ◊ The objective of auditing is to ensure accuracy, reliability, and fairness of financial information.
- ◊ Audit helps in detecting errors, frauds, and ensures compliance with laws and regulations.

◊ Audit and investigation are different; auditing verifies past financial records, whereas investigation examines specific matters or suspicions.

◊ Types of audits include continuous, statutory, interim, partial, complete, cash, cost, annual, balance sheet, management, government, internal, social, and tax audit.

◊ Auditor is a qualified person assigned the responsibility to examine and verify accounts.

◊ Qualities of an auditor include integrity, competence, objectivity, and diligence.

◊ Legal provisions for auditor appointment include eligibility criteria, rights, duties, and responsibilities as per Companies Act

Objective Questions

1. What is the origin of auditing?
2. Who is responsible for conducting an audit?
3. What is the main objective of auditing?
4. Name the audit conducted regularly to check accounts systematically.
5. Name the examination conducted for a specific purpose or suspicion.
6. Which audit examines all cash transactions?
7. Which audit is conducted by the company's own staff?
8. Which audit is mandatory as per law?
9. Which audit evaluates management efficiency?
10. Which audit assesses an organisation's social responsibility?

Answers

1. Audire
2. Auditor
3. Verification
4. Auditing

5. Investigation
6. Cash audit
7. Internal audit
8. Statutory audit
9. Management audit
10. Social audit

Self-Assessment Questions

1. Explain the different classifications of companies based on ownership.
2. What are the key distinctions between a Public Company and a Private Company?
3. Define a company as per Section 2(20) of the Companies Act, 2013.
4. What is meant by 'perpetual succession' in the context of a company?
5. List the three ways in which companies may be incorporated.
6. What distinguishes a 'Chartered Company' from a 'Statutory Company'?
7. Explain the liability of members in a company limited by shares.
8. What are the key characteristics of a Private Company as per Section 2(68) of the Companies Act, 2013?

Assignments

1. Explain the meaning and nature of auditing. Support your answer with real-life examples of how auditing ensures accuracy in financial statements.
2. Differentiate between audit and investigation. Highlight at least five points of distinction and give examples where each would be applicable.
3. Discuss the different types of audits. Explain the purpose, advantages, and limitations of at least four types of audits.
4. Describe the qualities and legal provisions required for the appointment of an auditor under the Companies Act, 2013. Include the provisions for first auditor, rotation, and reappointment.

5. Explain the objectives and significance of auditing. How does auditing help in protection of stakeholders' interests, prevention of fraud, and improvement of business processes?

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Unit 2

Internal Control

Learning Outcomes

After completing this unit, the learner will be able to:

- ◊ comprehend the concept of internal control and internal check
- ◊ discuss the concept of audit engagement
- ◊ describe the audit program
- ◊ identify the contents of audit working paper and audit note book
- ◊ explain the concept of audit evidence
- ◊ get an overview of internal audit

Prerequisite

Consider a large shopping complex, Maheshan Ltd, where hundreds of financial transactions occur daily rent collections, payments to suppliers, and sales from various outlets. To ensure everything runs smoothly and accurately, the company implements a strong internal control and internal check system, helping prevent errors and fraud. When an audit engagement is agreed upon, the auditor prepares a detailed audit program outlining the procedures to follow. During the audit, the auditor examines audit working papers and audit notebooks, recording observations, doubts, and key findings. Using audit evidence, such as invoices, receipts, and vouchers, the auditor verifies the accuracy of financial records. This process, often part of an internal audit, not only ensures compliance with laws and policies but also provides management with insights to improve operational efficiency and safeguard the company's assets

Keywords

Internal control, internal check, audit engagement, audit programme, Audit program, audit working paper, audit note book, internal audit

Discussion

4.2.1 Internal Control

The entire control system adopted by the management to conduct the business efficiently and effectively is called internal control. It includes all administrative and financial control systems including internal checks and internal audit. In other words, internal control includes all control systems adopted in a business to run it efficiently. Internal control ensures the reliability of financial reporting, enhances the effectiveness and efficiency of operations, and ensures compliance with relevant laws and regulations. The accounting control systems are standard costing, marginal costing, and budgetary control, self-balancing system, bank reconciliation, internal check and internal auditing. The administrative control systems are adopted for increasing the operational efficiency which includes statistical analysis, time study, motion study, performance report, quality control etc.

Objectives of internal control

The following are the key objectives of internal control:

a. Ensuring compliance with applicable laws, regulations, and accounting standards to maintain operational integrity and avoid legal repercussions.

b. Implementing controls to deter, prevent, and detect fraud, safeguarding the organisation's assets and reputation from loss, theft, or misuse.

c. Identifying and assessing potential risks to the organisation and establishing controls to minimise their impact.

d. Maximising the efficient utilisation of human, financial, and physical resources to enhance overall performance.

e. Continuously evaluating and refining business processes to improve efficiency, productivity, and quality.

f. Establishing systems to capture, process, and report accurate and reliable financial and operational data for informed decision-making.

g. Defining and distributing tasks and responsibilities among different individuals to prevent errors, fraud, and abuse of power.

h. Implementing performance metrics to assess organisational and individual performance, enabling timely corrective actions.

i. Protecting physical assets through security measures such as access controls, surveillance, and alarms.

There are three types of internal control systems: preventive, detective, and corrective. Preventive internal control systems are proactive in nature and prevent the occurrence of frauds, defects, and malpractices. Detective control systems focus on identifying frauds and defects that have already occurred. Corrective controls are implemented to rectify errors or irregularities as soon as they are identified.

The whole work of auditor depends on the efficiency of internal control system. If there is a good system of internal control, the auditor can rely upon test checking. However, if there is any mistake, the auditor cannot escape from his liability. A well-functioning internal control system is instrumental in safeguarding organisational resources and ensuring operational efficiency. By establishing clear guidelines for resource allocation and utilisation, it prevents misuse and promotes accountability. Furthermore, such a system plays a crucial role in error prevention and detection, contributing to the production of reliable financial records. Ultimately, internal controls protect the organisation's assets from misappropriation and irregularities by fostering a secure work environment through the implementation of appropriate segregation of duties and delegation of responsibilities. Internal check and internal audit are two sub-systems of internal control.

4.2.2 Internal Check

In a business, there are various steps of recording transactions such as recording the transaction in the journal, posting to the ledger, balancing of accounts, placing orders to suppliers, receiving cash from customers etc. If all these processes are allowed to be performed by the same person, chances of committing frauds and errors will be more. To avoid this problem, in large business organisations, the work is divided and internally arranged to each employee. No one is allowed to perform a work completely. This system of arrangement of work is called internal check system.

An internal check system is a method of organising the accounting system of a business concern or a factory by which the duties of various clerks are arranged in such a way that the work of one person is automatically checked by another. Thus, the possibility of fraud, error or irregularity is minimized.

According to FRM De Paula, "An internal check means practically a continuous internal audit carried on by the staff itself by means of which the work of each individual is independently checked by other members of the staff."

An example of internal check system of a cash receipts will make it clear. As soon as cash is received from a customer, it is recorded by the cashier on the debit side of cash book, the transaction is posted by another clerk in customer's account, it is cross checked by an officer and statement of account of the customer is prepared by another person. Here, no chances of errors or fraud is possible unless otherwise an understanding between all these employees.

4.2.2.1 Features of internal check

a. accounting work is divided among the employees.

b. No employee is permitted to perform a single work from the commencement to end.

c. Work of one employee is automatically checked by another employee.

d. Work is distributed on the basis of competence and qualification of employees.

e. This system is suitable to big business organisations.

4.2.2.2 Objects of internal check

a. To make sure that no transaction is unrecorded.

b. Early detection of errors and frauds.

c. By introducing division of labour, the efficiency of employees can be improved.

d. Prevent commission of errors and frauds because there is always checking of work of employees automatically.

e. It avoids the misappropriation goods and cash.

f. In case an error or fraud is committed, the responsibility can be fixed to the employee who has committed it.

4.2.2.3 Principles of Internal Check

a. No employee is allowed to perform a work completely.

b. Division of labour should be adopted.

c. Work should be divided on the basis of qualification and efficiency.

d. Make sure that there is no overlapping of work.

e. Responsibility of each employee should be fixed.

f. The system should ensure that the efficiency is increased.

g. The work of accounting department should be periodically reviewed.

h. Self-balancing system should be introduced.

i. Correspondence with debtors and creditors should be done under the supervision of a responsible officer.

j. There should be a good system of keeping documents like vouchers, correspondence etc.

k. Periodical physical stock verification is done by a person other than the employee who is in charge of stock.

l. All cash receipts should be deposited into bank daily.

m. Periodical cash and bank balance checking should be made.

n. Employees should be transferred from one department to another without prior notice.

o. Every employee is requested to go on leave for few days at least once in every year.

p. There should have effective control over purchases, receipts and issue of goods from the department.

4.2.2.4 Advantages of Internal Check

a. The efficiency of work is improved.

b. Rational allocation of work among employees.

c. It helps in detection and prevention of errors and frauds.

d. The work of the auditor is reduced to a great extent.

e. The auditor can rely upon test checking, therefore, it is possible to publish audited final accounts soon after closing the accounting year.

f. It increases the profitability of business due to increase in efficiency.

g. The owners can assure and rely upon the authenticity of accounts.

4.2.2.5 Limitations of Internal Check

a. The system is expensive and not possible to be introduced in small business.

b. The speed of work is important hence quality of work may be declined.

c. Auditors might depend heavily on the internal check system's perceived efficiency, using test checking (sampling) rather than a thorough examination. This approach might miss errors or fraud, especially if those errors are not part of the sampled transactions.

d. If there is an understanding between the employees, fraud can be easily committed.

4.2.2.6 Auditor's duty and Internal Check

There is no relationship between auditor's liability and auditor's duty in connection with internal check. Auditor is always liable if he is negligent. If there is an efficient system of internal check, the possibility of errors and frauds is minimum, hence, he can rely upon test checking. Test checking means checking a few transactions in random and if they are found correct, the auditor can presume that the remaining transactions are also correct. If any error is detected, he should go to a detailed checking. In short, relying upon the efficiency of internal check system, auditor adopts test checking; he cannot escape from his liability if there is any irregularity in auditing.

Table 4.2.1 Difference between internal check and internal control

Internal Check	Internal Control
Work of one employee checked by another person	Complete system of control measures introduced by management to run the business
Internal check is only a part of internal control	It includes both internal check and internal audit
Scope is limited and narrow	Scope covers a wide range of activities

4.2.3 Internal Audit

Internal audit is conducted by big organisations where the volume of transactions is large. It is conducted by a separate department in an organisation. It is a constant and systematic process of inspecting and reporting the operations and records of a concern. It is a continuous process of appraising the efficiency of operations and correctness of records.

Internal auditing is defined as "an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation to accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance process".

The internal auditor and external auditor perform similar audit functions. The report of the internal auditor is submitted to the management. The report contains his opinion about the efficiency of internal check system, internal control system and suggestions for improvement. Moreover, his opinion regarding the system in operation and suggestion for improvement should also be mentioned. In short, he has to report to the management whether or not the policies, procedures and plans framed by them are properly implemented.

Table 4.2.2 Differences between Internal Audit and Internal Control

Internal Audit	Internal Control
Systematic and continuous process of checking and reporting records and operations of a business by the employees	Complete system of control measures introduced by management to run the business
Part of internal control	Includes both internal check and internal audit
Primarily relates to auditing financial accounts and operational processes, ensuring compliance, and identifying areas for improvement	Encompasses the entire organisational system, including financial and non-financial controls

Scope of the internal audit

a. Evaluation of the application and efficacy of risk management procedures and risk assessment practices.

b. Appraisal of the management and financial information systems and electronic information system.

c. Evaluation of the accuracy and dependability of the accounting records and financial reports.

d. Evaluation of the economy and efficiency of the operations. Check-up and assessment of the adequacy and efficacy of the internal control systems.

e. Evaluation of the systems established to safeguard compliance with legal and regulatory requirements.

f. Testing of the reliability and suitability of the supervisory reporting.

g. Evaluation of the means of safeguarding assets.

h. Testing of transactions and the working of specific internal control procedures.

Table 4.2.3 Differences between Internal Check and Internal Audit

Internal Check	Internal Audit
The work of one person is automatically checked by another person	The work is checked after it is completed
The object is prevention of errors and frauds	The object is detection of errors and frauds
It is done by the staff of the organisation	It is an automatic review of operations
The scope is limited	The scope is wide

4.2.4 Preparation of an Audit

Preparation of an audit is a critical step that lays the foundation for a smooth and effective auditing process. Before commencing fieldwork, the auditor gathers detailed information about the organisation, its operations, and its financial systems to understand the business environment, risks, and internal control framework. This initial stage involves reviewing prior year audit reports, financial statements, and accounting policies, as well as obtaining an understanding of the nature and volume of transactions.

The auditor establishes the audit objectives based on the nature of the business, regulatory requirements, and management expectations. These objectives guide the planning and execution of audit procedures. A key part of audit preparation is determining the audit scope, which identifies the areas, accounts, and processes to be audited, along with the depth and timing of the audit procedures. Risk assessment is carried out to identify areas prone to error, fraud, or inefficiency, allowing the auditor to focus resources on high-risk areas.

Another important component of audit preparation is the development of an audit programme, which is a detailed plan outlining the nature, timing, and extent of audit procedures for each area of examination. The audit programme ensures that all critical areas are systematically examined, providing a roadmap for the audit team.

The auditor also prepares audit working papers and audit notebooks to record observations, findings, and evidence collected during the audit. These documents serve as proof of work performed, facilitate review by senior auditors, and provide a reference in case of disputes or queries. Audit working papers include schedules, reconciliations, confirmations, and supporting documents, while the audit notebook records doubts, queries, errors, or unusual transactions encountered during the audit process.

Proper communication with management before starting the audit is crucial to clarify the objectives, obtain necessary information, and ensure cooperation from various departments. The auditor may also issue an engagement letter, which formalizes the audit assignment, defines the responsibilities of both parties, and establishes the terms and conditions of the audit engagement.

In summary, audit preparation involves comprehensive planning, risk assessment, defining objectives and scope, preparing detailed audit programmes, and ensuring proper documentation. This stage not only enhances the efficiency and effectiveness of the audit process but also ensures that audit findings are accurate, reliable, and useful for decision-making by management and stakeholders.

4.2.5 Audit Engagement

Audit engagement is an agreement between the client and the auditor relating to the nature, scope, and purpose of the audit. At the beginning of an audit, the client and auditor agree on the services to be provided, the remuneration payable, and the period during which the audit will be conducted. For this, the auditor prepares an agreement that contains his terms and conditions. It also shows all of the work performed by him for a client. This letter is called an engagement letter which is sent to the client. If the client agrees with the terms specified in the letter, a person authorized to do so will sign the letter and return a copy to the auditor. Hence, the parties indicate that an audit engagement has been initiated. This letter is useful for avoiding disputes in the future.

4.2.6 Audit Programme

Audit programme is a detailed plan of auditing. It contains the details of work to be done, instructions, and guidelines given to the audit staff related to how they proceed with the audit work. In the words of Megis, "an audit programme is a detailed plan of audit work to be performed, specifying the procedure to be followed in verification of each item in the financial statements and giving the estimated time required". Audit programme is prepared for the purpose of assuring each item has been checked, fixing responsibility to the audit clerk who has done a particular work, predetermining the starting and ending time of work etc. The audit programme contains the work assigned to each clerk and they have to sign it as and when they complete the assigned work. Audit programme is drafted by the auditor. It is prepared before commencement of the audit and it clearly shows the procedure of audit work to be done.

Advantages

- Audit work can be completed within the stipulated time.
- Auditor can control and coordinate the work of audit staff simultaneously.
- Responsibility of each work can be fixed against the person doing it.
- It assures that no part of audit work has been omitted from checking.
- It gives clear guidance to the audit staff to perform the work.

Disadvantages

- ◊ If a particular work is not included in the audit programme, that part of work remains unchecked.
- ◊ It is not suitable to small business and therefore not feasible.
- ◊ The audit staff may lose interest and initiative of audit because the audit is going mechanically.

4.2.7 Audit Working Papers

Audit working papers are the papers and documents which contain all important details about the accounts which are under audit. They connect the relation between clients' accounting records and the auditor's report. It exhibits true image of accounts of the business. The working papers show that the auditors followed the rules and guidelines that are widely accepted in the auditing profession. This means they did the audit properly and professionally.

Objectives for preparing working papers

- ◊ It assists the auditor to organise and coordinate the work of audit staff.
- ◊ It is the base for preparing auditor's report.
- ◊ It helps the auditor to draft audit plan for coming financial year.
- ◊ In case some negligence is charged against the auditor, he can produce audit working papers as evidence in the court of law.
- ◊ Auditor can make sure that his staff had followed his instructions in the course of work.

Contents of Working Papers

- ◊ Rough trial balance
- ◊ Draft final accounts
- ◊ Details of investments
- ◊ Schedule of debtors and creditors, correspondence between the auditor and debtors, creditors, and bank

Essentials of Good Working Papers

- ◊ It should be simple, easily understandable, and self-explanatory.
- ◊ Properly arranged, filed, and numbered.
- ◊ Essential and relevant information needs to be included.
- ◊ There should be clarity in thought and expression.

The audit working papers are the property of the auditor. This document is very confidential and important. Therefore, it must be kept safe with high care and concern. If the audit work is in progress, it must be in the client's office under strict control. After completing the audit, it shall be kept under the custody of the auditor. The information in the working papers is confidential; if it is disclosed without the consent of the client, the auditor is deemed guilty of misconduct under the Chartered Accountant Act of 1949.

4.2.8 Audit Note Book

In the course of audit, the audit staff may come across many problems related to the work done. Therefore, they usually maintain a diary or notebook for recording notes on the doubts, errors, queries, and problems faced by them in the course of audit. The doubts which are not clarified by the client and the points to be discussed with the main auditor etc. are recorded in the audit notebook.

An audit notebook includes the following points:

- ◊ The details of supporting documents missing, such as vouchers, receipts, bills, invoices, etc. not produced.
- ◊ The starting and ending date of audit.
- ◊ Particulars of errors, fraud, and mistakes detected.
- ◊ Name, designation, functions, and responsibilities of principal officers of the company.
- ◊ Balances of various accounts, their totals, etc.

4.2.9 Audit Evidence

An auditor is appointed to examine the books of accounts and other documents to express his opinion about the accuracy and authenticity of books of accounts. Hence, he should satisfy himself regarding the accuracy and authenticity of transactions. For ensuring it, he has to examine all supporting documents such as vouchers, invoices, bills, correspondence, etc. These supporting documents are called audit evidence. Audit evidence is defined as "any documents, material or other source which is available to substantiate any assertion made in financial statements or transactions recorded in the books of accounts".

The audit evidence can be classified into three types: documentary evidence, physical evidence, and accounting system.

- ◊ **Documentary Evidence :** Supporting documents such as vouchers, invoices, receipts, carbon copies of receipts, correspondence with various parties, etc., are called documentary evidence.
- ◊ **Physical Evidence :** The auditor should satisfy himself regarding the physical existence of tangible assets like cash, stock, land, building, plant, and machinery. The greatest evidence in case of these tangible assets is their physical existence. The auditor should physically examine and satisfy himself regarding their existence and value.
- ◊ **Accounting System :** Accounting system is like a manufacturing process. Inputs such as transactions, supporting evidences, and vouchers are introduced, producing accounts balances as the final product. The auditor has to verify the figures of the financial statement and assure its correctness.

The object of an audit is to enable the auditor to express an opinion whether the financial statements are prepared in conformity with recognised financial reporting frameworks such as GAAP and in all material respects. Information is material if its omission or misstatement could influence the economic decisions of users.

The concept of true and fair view indicates that the balance sheet and profit and loss account show fairly the actual financial position and financial result of that period. It is based on the auditor's judgement in the particular situation of the case. Financial statements must conform to the financial reporting framework and be prepared in all material respects, ensuring they are understandable, comparable, relevant, and reliable

Recap

- ◊ Internal Control is a complete system of administrative and accounting controls designed to ensure efficient operations, reliability of financial reporting, and prevention of fraud.
- ◊ Internal Check is a method in which no employee handles a task fully, ensuring that one person's work is automatically checked by another to prevent errors and fraud.
- ◊ Internal Audit is a continuous and independent review of operations and records carried out to evaluate the effectiveness of internal controls and ensure compliance.
- ◊ Preparation of an Audit is the process of planning an audit by understanding the business, setting objectives, assessing risks, preparing audit programmes, and organising documentation.
- ◊ Audit Engagement is a formal agreement between the auditor and the client that defines the scope, responsibilities, and terms of the audit.
- ◊ Audit Programme is a detailed plan that outlines the audit procedures to be followed for verifying each item in the financial statements.
- ◊ Audit Working Papers are documents that contain audit evidence, procedures performed, and findings which support the auditor's conclusions.
- ◊ Audit Note Book is a diary maintained by audit staff to record doubts, errors, missing documents, and issues that need clarification.
- ◊ Audit Evidence includes all documents and information that support the accuracy and authenticity of financial transactions and financial statements.

Objective Questions

1. What ensures efficient business control?
2. What system checks one employee's work by another?
3. Which audit is continuous within an organisation?
4. What outlines audit procedures?
5. What formalises the audit agreement?
6. What records audit doubts and queries?
7. What contains audit evidence and schedules?
8. What verifies transaction authenticity?
9. What process begins audit planning?
10. What ensures reliability of financial records?

Answers

1. Internal Control
2. Internal Check
3. Internal Audit
4. Programme
5. Engagement
6. Notebook
7. Working Papers
8. Evidence
9. Preparation
10. Control

Self Assessment Questions

1. Explain the concept of internal control in an organisation.
2. Describe how internal check helps in preventing errors and fraud.
3. Discuss the meaning and role of internal audit within an organisation.
4. Explain what is meant by the preparation of an audit.
5. Discuss the concept of an audit engagement.
6. Describe the purpose and structure of an audit programme.
7. Explain what audit working papers are.
8. Describe the importance of an audit note book in auditing.
9. Discuss the meaning of audit evidence.

Assignments

1. Visit near firm and prepare report on Internal Control Measures taken by firm ?
2. Conduct a Interview with familiar auditor and write down his steps for preparation for an audit
3. Compare Internal check and Internal audit. Explain with examples?

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5

BLOCK

Vouching, Verification and Audit Report

Unit 1

Vouching and Verification

Learning Outcomes

After completing this unit, the learner will be able to:

- comprehend the concept of vouching
- identify requirements of vouchers
- get an idea about verification of assets and liabilities
- describe the concept of valuation of assets
- discuss the precautions while taking verification of assets and liabilities

Prerequisite

In a small town near Aluva, Kerala, a family-run wholesale grocery business named Malabar Traders applied for a bank loan to expand its godown, for which an audit was required. During the audit, the auditor examined purchase bills, sales invoices, cash receipts, and bank statements to confirm that the transactions recorded in the books were genuine, such as verifying a rice purchase from a Palakkad supplier with proper invoices and payment proof this process is known as vouching. The auditor then physically checked the closing stock in the godown, verified ownership of the building, inspected delivery vehicles, and confirmed bank balances to ensure that the assets and liabilities shown in the balance sheet actually existed, belonged to the business, and were correctly valued this is called verification.

Keywords

Vouching, Voucher, Verification, Valuation

Discussion

In every business organisation, numerous financial transactions take place on a daily basis. These transactions are recorded in the books of accounts on the basis of documents such as bills, invoices, receipts and agreements. During an audit, the auditor cannot simply rely on figures shown in the ledger or cash book. Instead, the auditor must satisfy himself that each transaction recorded is genuine, properly authorised and supported by reliable evidence. This detailed examination of book entries with supporting documents is known as vouching.

To understand this better, consider a situation where a firm records an expense for office stationery. The entry by itself does not prove anything unless it is supported by a proper bill issued by the stationery supplier. When the auditor examines this bill and matches it with the entry in the books, he gains assurance that the transaction is real and related to the business. In this way, vouching acts as the foundation upon which the entire audit work is built.

5.1.1 Vouching

Vouching is the process of verifying the entries recorded in the books of accounts with the help of documentary evidence called vouchers. It involves tracing each transaction from the books back to its original source document in order to establish its accuracy and authenticity. Vouching as the act of proving entries in the books by examining the documents that support them.

Joseph Lancaster defines vouching as "the act of proving entries in the books of account by documentary evidence", while R.G. Williams explains it as "testing the truth of the entries appearing in the books of account."

In practice, vouching means that when an auditor comes across an entry such as payment of rent or purchase of goods, he does not accept it at face value. Instead, he examines the rent receipt or purchase invoice, checks the date, amount, name of the party and authorisation, and then ensures that the entry has been recorded in the correct account and accounting period. Thus, vouching helps the auditor to confirm that the transaction is genuine, properly recorded and related to the business.

5.1.1.1 Importance of Vouching

- ◊ Establishes Genuineness of Transactions : Vouching helps the auditor to confirm that transactions recorded in the books have actually taken place and are not fictitious or imaginary.
- ◊ Ensures Accuracy of Accounting Records : By matching book entries with vouchers, errors relating to amounts, dates and posting can be detected and corrected.

- ◊ Helps in Detection of Frauds : Fraudulent practices such as inflated expenses, forged vouchers and duplicate payments can be identified through careful vouching.
- ◊ Prevents Misappropriation of Cash and Assets : Regular vouching discourages employees from misusing cash or assets, as transactions are subject to verification.
- ◊ Ensures Proper Authorisation : Vouching confirms that transactions are approved by responsible officers according to the internal control system of the organisation.
- ◊ Verifies Business Relevance of Transactions : It helps in ensuring that only : business-related expenses and incomes are recorded and personal transactions are excluded.
- ◊ Supports Correct Classification of Transactions : Through vouching, the auditor ensures that capital and revenue items are correctly classified.
- ◊ Provides Basis for Audit Opinion : Since audit conclusions are based on verified transactions, vouching provides a strong foundation for expressing audit opinion.

5.1.2 Voucher

A voucher is documentary evidence which supports and justifies a transaction recorded in the books of accounts. It represents the written proof on the basis of which accounting entries are made and later verified during audit. Auditing literature describes a voucher as the link between the transaction and its record in the books.

In practical business situations, every transaction leaves behind some documentary trail. When goods are purchased, a supplier's invoice is received; when rent is paid, a rent receipt is obtained; when salaries are paid, salary sheets and payment statements are prepared. These documents act as vouchers and give substance to accounting entries.

Vouchers serve several purposes. They help management to record transactions systematically, provide evidence in case of disputes and assist auditors in verifying the correctness of entries. Without vouchers, accounting records would merely be statements without proof.

Vouchers may be classified into primary and secondary vouchers. Primary vouchers are original documents prepared at the time of the transaction and are considered the most reliable form of evidence. For example, an original purchase invoice issued by a supplier gives strong assurance about the authenticity of a purchase transaction. Auditors rely heavily on such vouchers while forming their conclusions.

Secondary or collateral vouchers are copies or substitute documents used when original vouchers are not available. These may include duplicate invoices, photocopies or counterfoils. Although they support transactions, auditors treat them with greater caution. In such cases, the auditor may seek additional confirmation or corroborative evidence before accepting the entry as genuine.

Thus, vouchers form the backbone of both accounting and auditing. They ensure transparency, accountability and reliability in financial reporting by providing documentary support for every transaction recorded in the books. Let us discuss the requirements of a voucher in detail.

5.1.2.1 Requirements of a voucher

A voucher is documentary evidence supporting a business transaction recorded in the books of accounts. For the purpose of auditing, it is not enough that a voucher merely exists; it must also satisfy certain essential requirements to be considered valid, reliable, and acceptable.

An auditor examines vouchers carefully to ensure that they fulfil these requirements before relying on them as evidence.

1. **Proper Authorisation :** Every voucher must be properly authorised by a competent and responsible officer of the organisation. Authorisation confirms that the transaction has been approved according to the internal control system of the business. For instance, salary vouchers are expected to carry the approval of the authorised signatory or the human resources department; an unauthorised voucher may indicate the possibility of fraudulent or irregular payments.
2. **Name of the Business Entity :** A valid voucher should clearly mention the name of the business entity to which the transaction relates. This requirement ensures that the transaction belongs to the organisation under audit and not to the personal dealings of owners or employees. Where a purchase invoice is issued in the personal name of a proprietor or partner instead of the firm, the auditor must be satisfied that the expense was incurred for business purposes.
3. **Date of the Transaction :** The voucher must state the exact date on which the transaction occurred. The presence of a proper date helps the auditor verify that the transaction has been recorded in the correct accounting period. Bills such as electricity charges or rent receipts dated at the end of the financial year require special attention to ensure that they are not carried forward or shifted to manipulate profits.
4. **Amount Clearly Stated :** A voucher should show the correct amount of the transaction clearly and unambiguously. The amount is preferably stated in figures and supported by necessary details. Any alteration in the amount without proper authentication reduces the reliability of the voucher and raises suspicion regarding its genuineness.
5. **Nature and Purpose of the Transaction :** The voucher must clearly explain the nature and purpose of the transaction so that the auditor can understand why the expense was incurred or income received. Vouchers that merely describe expenses as "miscellaneous" without sufficient explanation are considered inadequate, as they do not enable proper classification or verification of the transaction.

6. **Name and Signature of the Payee :** A valid voucher should contain the name and signature of the payee, confirming that payment has actually been received. This is particularly important in cash transactions such as wages or petty cash payments, where the absence of a proper signature or acknowledgement may indicate fictitious payments.
7. **Classification as Revenue or Capital :** The voucher should provide sufficient information to determine whether the expenditure is revenue or capital in nature. Correct classification is essential for the accurate determination of profit. For example, expenditure incurred on acquiring a fixed asset must be supported by a voucher that clearly indicates its capital nature, rather than being treated as routine maintenance.
8. **Compliance with Legal Requirements :** Where required by law, the voucher should be properly stamped. The presence of a revenue stamp on certain receipts enhances the legal validity of the document and increases its evidentiary value. An unstamped receipt, where stamping is mandatory, cannot be considered a complete and reliable voucher.
9. **Original Document :** As a general rule, the auditor should rely on original vouchers rather than copies or duplicates. Original documents provide stronger and more reliable audit evidence. Copies may be accepted only in exceptional circumstances, such as when the original has been lost and satisfactory explanations are provided.
10. **Transaction Must Relate to Business :** The voucher should establish that the transaction was incurred wholly and exclusively for business purposes. Personal expenses of owners or employees, even if supported by documents, cannot be treated as business expenses. This requirement ensures that profits are not understated due to the inclusion of non-business expenditures.
11. **Proper Filing and Reference :** A voucher should be serially numbered, properly filed, and cross-referenced with the relevant book of accounts. Proper filing facilitates easy verification, strengthens internal control, and enables the auditor to trace transactions efficiently during the audit process.

From the above discussion, it is evident that a voucher is not merely a supporting document but the primary foundation of audit evidence. Only when vouchers are complete, properly authorised, genuine, legally valid, and directly related to business transactions can they be relied upon by the auditor. Effective vouching depends largely on the quality and reliability of vouchers maintained by the organisation. However, the examination of vouchers alone does not provide absolute assurance regarding the truth and fairness of financial statements. After ensuring the authenticity of transactions through vouching, the auditor must further satisfy himself about the existence, ownership, valuation, and disclosure of assets and liabilities. This brings us to the next important stage of audit, namely Verification, which deals with the detailed examination of assets and liabilities as shown in the balance sheet.

5.1.3 Verification

A college canteen records in its account book that it purchased groceries worth ₹15,000 from a local supplier at the end of the month. The entry is neatly written, totals are correct, and the account appears complete. However, before accepting this as true, someone needs to confirm whether this purchase actually took place in the manner recorded. The bill from the supplier is checked to see the date, items, and amount. The store register is looked into to confirm that the groceries were received. The cash book or bank statement is examined to ensure payment was made to the same supplier for the same amount. When all these records support one another, the purchase entry is accepted as genuine.

This process of confirming the truth and accuracy of recorded information with the help of supporting evidence is known as verification. It goes beyond merely reading records; it involves carefully examining documents, facts, and circumstances to ensure that what is stated is real, correct, and complete. Verification helps establish reliability, prevents errors and fraud, and ensures that records truly represent actual events. In simple terms, verification converts written information into trusted information by linking records with proof from real-life evidence.

Verification and vouching, it is important to recognize that both are closely connected steps in the process of examining records, yet they serve different purposes. At first glance, they may appear similar because both involve checking and confirming information using evidence. However, they differ in direction, focus, and objective. While one looks at whether transactions recorded in the books are supported by proper documents, the other goes a step further to confirm the truth, existence, and value of what those records represent. This distinction becomes clearer when we examine verification and vouching side by side.

Table 5.1.1 Difference between Vouching and Verification

Basis of Difference	Vouching	Verification
Meaning	Vouching is the process of examining entries in the books of accounts with the help of documentary evidence called vouchers.	Verification is the process of confirming the existence, ownership, valuation, and accuracy of assets and liabilities shown in the books.
Nature	It is a routine and detailed checking of transactions.	It is a broader and more analytical examination of balances and facts.
Main Objective	To ensure that transactions recorded in the books are genuine, properly authorized, and supported by documents.	To ensure that assets and liabilities shown in the balance sheet are real, correctly valued, and belong to the business.
Stage of Audit	It is usually undertaken during the examination of day-to-day transactions.	It is generally carried out at the time of finalization of accounts.

Direction of Checking	It involves checking from books of accounts to vouchers (backward checking).	It involves checking from balance sheet items to supporting evidence and physical existence.
Scope	Limited to verifying transactions recorded in the books.	Wider in scope as it includes physical inspection, valuation, and legal ownership.
Focus	Focuses on income and expenditure items recorded in books.	Focuses mainly on assets and liabilities shown in the balance sheet.
Example	Checking a purchase entry with its invoice, receipt, and authorization.	Confirming that the asset purchased actually exists, is owned by the business, and is properly valued.

After understanding the difference between vouching and verification, the next step is to know how these two processes are actually carried out in practice. Merely knowing that vouching checks transactions and verification confirms assets and liabilities is not sufficient unless they are performed systematically and logically. To ensure uniformity, accuracy, and reliability in examination, auditors follow certain well-defined rules known as principles. These principles act as guiding standards that help in conducting vouching and verification in a proper and consistent manner.

5.1.4 Principles

When an auditor vouches a purchase transaction, simply matching the entry with a bill is not enough. The auditor must ensure that the bill is original, properly authorized, relates to the correct period, and represents a genuine business expense. Similarly, while verifying machinery shown in the balance sheet, it is not sufficient to rely on book figures alone; the auditor must confirm that the machinery actually exists, belongs to the business, is correctly valued after depreciation, and is free from any undisclosed charge. Such practical situations clearly show why specific principles are necessary to guide the process of vouching and verification, leading us to a detailed study of their principles. Following are the principles of verification:

1. **Existence of Assets and Liabilities :** Assets and liabilities shown in the balance sheet must actually exist on the date of verification.
2. **Ownership and Rights :** Assets must legally belong to the business, and liabilities must represent genuine obligations of the business.
3. **Correct Valuation :** Assets and liabilities should be valued according to accepted accounting principles and consistently followed methods.
4. **Proper Disclosure :** All material facts relating to assets and liabilities must be clearly disclosed in the financial statements.
5. **Physical Inspection :** Wherever possible, assets such as cash, stock, and fixed assets should be physically inspected.
6. **Freedom from Charge :** Assets should be verified to ensure they are free from undisclosed charges, liens, or mortgages.

After understanding the principles of verification, it becomes clear that merely confirming the existence and ownership of assets is not sufficient. An asset may physically exist and legally belong to the business, yet still be shown at an incorrect value in the balance sheet. This is where the principle of correct valuation assumes great importance. Verification ensures that assets are real, while valuation ensures that they are shown at a fair and reasonable amount. To appreciate this connection, valuation of assets must be understood not as a mechanical calculation, but as a careful judgement guided by accounting principles and practical realities.

5.1.5 Valuation of Assets

Consider a manufacturing company that purchased a machine five years ago for ₹10,00,000. During verification, the auditor physically inspects the machine and confirms that it exists and is owned by the business. However, showing the machine at its original cost would misrepresent the financial position, as the machine has been used continuously and has lost part of its value due to wear and tear. Therefore, depreciation is charged every year, and the machine is shown at cost minus depreciation. This illustrates how verification leads naturally to valuation, ensuring that assets are not overstated.

Valuation of assets refers to the process of determining the correct monetary value at which assets should appear in the balance sheet. It ensures that assets are neither overstated nor understated and that the financial statements present a true and fair view. If assets are valued incorrectly, users of financial statements such as investors, creditors, and management may be misled into making unsound decisions. Thus, valuation acts as a safeguard against distortion of financial information.

1. **Fixed Assets :** Fixed assets such as land, buildings, machinery, and furniture are valued at their original cost minus depreciation. The cost includes purchase price, installation charges, transportation, and any other expenses incurred to bring the asset into working condition. Depreciation is charged systematically to allocate the cost of the asset over its useful life, ensuring that the asset is not shown at an inflated value.
2. **Current Assets :** Current assets like stock, debtors, and cash are valued with special care because they frequently change. Stock-in-trade is valued at cost or net realizable value, whichever is lower, to follow the principle of prudence. Debtors are shown at the amount expected to be realized, after deducting bad debts and provision for doubtful debts. Cash is valued at its actual balance as verified by physical cash count or bank statements.
3. **Intangible Assets :** Intangible assets such as goodwill, patents, trademarks, and copyrights are valued based on cost or expected future benefits. Goodwill is usually recorded only when it is purchased and is written off gradually. Intangible assets should be reviewed regularly to ensure they are not overstated and still provide economic benefits to the business.

4. **Investments :** Investments may be valued differently depending on their nature. Long-term investments are generally valued at cost, unless there is a permanent decline in value. Short-term or marketable investments are valued at cost or market value, whichever is lower. This ensures that any expected loss is recognized, while unrealized gains are ignored.

The auditor does not usually value assets personally but verifies whether assets are valued according to generally accepted accounting principles and consistently followed methods. The auditor examines supporting documents, checks depreciation calculations, ensures adequate provisions are made, and confirms proper disclosure in financial statements. If the valuation is not proper, the auditor must report it clearly.

Valuation of assets is a crucial part of verification and financial reporting. It ensures that assets are shown at realistic values, reflects the true financial position of the business, and protects the interests of stakeholders. Proper valuation, supported by sound principles and consistent methods, enhances the reliability and usefulness of financial statements.

After understanding the valuation of assets, it becomes evident that determining the correct monetary value is only one part of presenting assets in the financial statements. Even when assets are carefully valued using accepted accounting principles, a further question remains have these assets actually been examined to confirm their existence, ownership, and condition? This leads to the need to clearly distinguish between verification and valuation. While valuation focuses on how much an asset should be shown for in the balance sheet, verification is concerned with whether the asset truly exists and belongs to the business. Understanding the difference between verification and valuation helps in appreciating their distinct roles and how together they ensure a true and fair view of the financial position.

Table 5.1.2 Difference between Verification and Valuation

Basis of difference	**Verification of Assets**	**Valuation of Assets**
Meaning	Verification of assets is the process of confirming the existence, ownership, and authenticity of assets shown in the balance sheet.	Valuation of assets is the process of determining the correct monetary value at which assets should be shown in the balance sheet.
Main Objective	To ensure that assets actually exist and belong to the business.	To ensure that assets are shown at a fair, realistic, and appropriate value.
Nature	It is an investigative and confirmatory process.	It is a measurement and judgement-based process.
Focus	Focuses on physical existence, legal ownership, and condition of assets.	Focuses on cost, depreciation, provisions, and market value considerations.

Scope	Limited to examining the reality and ownership of assets.	Wider in scope as it includes application of accounting principles and estimation.
Timing	Generally carried out during audit verification of balance sheet items.	Usually done at the time of preparing final accounts.
Responsibility	Primarily the responsibility of the auditor.	Primarily the responsibility of management, reviewed by the auditor.
Method	Includes physical inspection, checking documents, and confirmations.	Includes applying valuation methods like cost, net realisable value, and depreciation.
Risk Addressed	Prevents showing fictitious or non-existent assets.	Prevents overvaluation or undervaluation of assets.
Outcome	Confirms that assets shown are genuine.	Ensures that assets are shown at correct values.

Verification of assets is a vital part of audit work, as assets represent the economic resources of the business. The auditor must satisfy himself that the assets shown in the balance sheet exist, belong to the business, are properly valued, and are free from undisclosed charges. Since different types of assets have different characteristics, the method of verification also differs from asset to asset.

5.1.6 Verification of Assets

Verification of assets is a vital part of audit work, as assets represent the economic resources of the business. The auditor must satisfy himself that the assets shown in the balance sheet exist, belong to the business, are properly valued, and are free from undisclosed charges. Since different types of assets have different characteristics, the method of verification also differs from asset to asset.

1. **Verification of Cash in Hand :** Cash in hand is the most liquid asset and also the most susceptible to misappropriation. Therefore, its verification requires special care. The auditor verifies cash by physically counting the cash on the date of the balance sheet or as close to that date as possible. The actual cash balance is then compared with the balance shown in the cash book.

   If any difference is noticed, the auditor investigates the reasons immediately. Temporary advances, unpaid vouchers, or errors in recording may explain minor differences. However, unexplained shortages may indicate misappropriation or fraud.If the cash book shows a balance of ₹50,000, the auditor must count the actual cash available. If only ₹48,000 is found, the auditor must enquire into the missing amount and ensure proper explanation and adjustment before certifying the accounts.

2. **Verification of Cash at Bank :** Cash at bank is verified by examining the bank statement, passbook, and bank confirmation certificate obtained directly from the bank. The auditor prepares or reviews the bank reconciliation statement to reconcile differences between the cash book and the bank statement.

   Special attention is given to outstanding cheques, cheques issued but not presented, and cheques deposited but not yet credited. The auditor also checks for stale or outdated cheques, as such cheques may sometimes be shown deliberately to conceal shortages of cash. Thus, verification of cash at bank ensures accuracy, existence, and correctness of cash balances shown in the balance sheet.

3. **Verification of Loans and Advances (Assets) :** Loans and advances given by the business are verified by examining loan agreements, sanction letters, repayment schedules, and security documents. The auditor ensures that such loans are genuine, authorised, and recoverable. Interest received or accrued on loans must also be checked for accuracy. Where loans are secured, the auditor verifies the existence and adequacy of security offered. If the business has advanced a loan against property, the auditor examines the mortgage deed, registration documents, and ownership records of the property to ensure the security is valid and enforceable.

4. **Verification of Stock in Trade :** Stock in trade usually forms a significant portion of current assets and directly affects the profit of the business. The auditor verifies stock mainly through physical inspection and by observing the stock-taking process conducted by the management.

   The auditor ensures that stock belongs to the business and that goods held on consignment are excluded. He also checks whether stock is valued at cost or net realisable value, whichever is lower, in accordance with the principle of prudence. Damaged, obsolete, or slow-moving stock must be identified and valued appropriately to avoid overstatement of profits

5. **Verification of Fixed Assets :** Fixed assets such as land, buildings, machinery, furniture, and vehicles are verified with reference to their physical existence, ownership, valuation, and disclosure. The auditor inspects the assets physically wherever possible and verifies purchase invoices, installation reports, and asset registers. Depreciation is checked to ensure that it is calculated using a consistent and appropriate method. For land and buildings, title deeds, registration documents, and municipal records are examined to confirm ownership. The auditor also ensures that fixed assets are free from undisclosed mortgages or charges.

6. **Verification of Investments :** Investments are verified by examining investment certificates, demat statements, contract notes, and broker confirmations. The auditor confirms whether investments are held in the name of the business and properly classified as current or long-term investments.

   Valuation is checked carefully. Long-term investments are generally shown at cost unless there is a permanent decline in value, while current investments are valued at cost or market value, whichever is lower.

7. **Verification of Debtors and Receivables :** Debtors are verified by examining the sales ledger, invoices, and correspondence with customers. The auditor may send balance confirmation letters to selected debtors to confirm outstanding balances. Recoverability of debts is assessed, and adequate provision for bad and doubtful debts is examined. Long-outstanding or disputed debts are carefully reviewed to ensure they are not overstated. Thus, debtors are shown at the amount expected to be realised.

8. **Verification of Intangible Assets :** Intangible assets such as goodwill, patents, trademarks, and copyrights do not have physical existence, making their verification more complex. The auditor verifies these assets through legal documents, agreements, and valuation records. Goodwill is verified by examining purchase agreements and ensuring that it arises from a genuine transaction. The auditor also checks whether such assets are written off systematically and not overstated in the balance sheet.

5.1.7 Verification of Liabilities

Verification of liabilities is equally important because liabilities represent obligations of the business. The main objective here is to ensure completeness, so that no liability is omitted or understated.

1. **Verification of Trade Payables :** Trade payables are verified by examining purchase records, supplier invoices, and statements received from suppliers. The auditor may send confirmation letters to major suppliers to confirm balances outstanding.

   This procedure ensures that liabilities are genuine and that no liability has been omitted deliberately to inflate profits.

2. **Verification of Loans and Borrowings :** Loans are verified by examining loan agreements, bank confirmations, interest calculations, and repayment schedules. The auditor ensures that loans are correctly classified as long-term or short-term and that interest liabilities are properly provided for. Any security offered against loans must be disclosed in the balance sheet.

3. **Verification of Outstanding Expenses :** Outstanding expenses such as wages, rent, electricity, and salaries are verified by examining bills, contracts, and payment records. Even though these expenses are not yet paid, they must be included as liabilities if they relate to the current accounting period. This ensures proper matching of income and expenses.

4. **Verification of Contingent Liabilities :** Contingent liabilities do not result in immediate payment but may arise in future depending on certain events. The auditor reviews legal correspondence, guarantees, and claims to identify such liabilities. Though not shown in the balance sheet, contingent liabilities must be clearly disclosed in the notes to accounts.

5. **Verification of Reserves and Provisions :** Provisions such as provision for taxation or provision for doubtful debts are verified to ensure they are adequate and reasonable. The auditor checks calculations and compliance with accounting standards and legal requirements.

While verifying a building, the auditor inspects the structure, examines the title deed, checks insurance policies, and ensures that no undisclosed mortgage exists.In verifying trade creditors, the auditor reconciles ledger balances with supplier confirmations to ensure completeness. For machinery, the auditor physically inspects the asset, verifies purchase documents, and recalculates depreciation to ensure that the carrying amount is reasonable. During verification, the auditor prepares detailed work-papers such as inspection notes, confirmation replies, reconciliation statements, valuation workings, and notes on discrepancies. These work-papers serve as audit evidence and support the auditor's opinion.

Verification may be difficult due to restricted access to assets, subjective valuation of intangibles, incomplete records, or delayed third-party confirmations. The auditor must exercise professional judgement in such cases.

Verification of assets and liabilities is a cornerstone of auditing. It ensures that the balance sheet presents a true and fair view by confirming existence, ownership, valuation, and completeness. Through careful examination and professional judgement, the auditor bridges the gap between book records and actual financial reality.

5.1.8 Precautions in Verification of Assets and Liabilities

While verifying assets and liabilities, the auditor must exercise due care, professional scepticism, and sound judgement. Verification is not a mere routine task; it requires alertness to errors, fraud, and misrepresentation. Certain precautions must therefore be observed to ensure that the verification process is reliable and effective.

1. **Verification Should Be Based on Reliable Evidence :** The auditor should rely only on authentic and relevant documentary evidence such as invoices, title deeds, agreements, bank confirmations, and certificates. Photocopies or informal documents should not be accepted unless properly certified. Where external confirmation is possible, such as bank balances or debtors, direct confirmation should be obtained.
2. **Physical Inspection Wherever Possible :** For tangible assets like cash, stock, machinery, and buildings, the auditor should carry out physical inspection or personally observe the verification carried out by management. Mere reliance on book records is insufficient, as fictitious assets may be recorded in the books.
3. **Verification Should Be Done on the Balance Sheet Date :** Assets and liabilities should be verified as on the balance sheet date. If verification is conducted on a different date, the auditor must reconcile transactions occurring between the date of verification and the balance sheet date to ensure accuracy.
4. **Ownership and Title Must Be Carefully Examined :** Existence alone is not enough; the auditor must ensure that assets legally belong to the business. Title deeds, registration documents, and agreements should be examined carefully. Assets taken on lease, hire purchase, or consignment must be properly disclosed and not wrongly shown as owned assets.
5. **Valuation Should Follow Accepted Accounting Principles :** The auditor must ensure that assets and liabilities are valued in accordance with generally

accepted accounting principles and that the method of valuation is consistently followed. Overvaluation or undervaluation must be avoided, and appropriate depreciation and provisions should be made.

6. **Assets Must Be Free from Undisclosed Charges or Liens :** The auditor should verify whether assets are subject to any mortgage, charge, or lien. Loan agreements and bank correspondence must be examined to ensure that such charges are properly disclosed in the balance sheet.
7. **Completeness of Liabilities Must Be Ensured :** While verifying liabilities, special care should be taken to ensure that all liabilities are recorded. Outstanding expenses, accrued liabilities, and contingent liabilities should not be omitted, as omission would result in overstatement of profits.
8. **Proper Classification and Disclosure :** Assets and liabilities should be properly classified as current or non-current and disclosed in accordance with statutory and accounting requirements. Material items should be disclosed separately, and adequate notes should be provided where necessary.
9. **Use of Third-Party Confirmations :** Wherever possible, the auditor should obtain independent confirmations from third parties such as banks, debtors, creditors, and lenders. Such confirmations increase the reliability of verification.
10. **Avoidance of Management Bias :** The auditor should not blindly rely on explanations provided by management. Professional scepticism must be maintained, especially in areas involving estimates, provisions, and subjective judgement.
11. **Consistency in Methods :** The auditor should ensure that methods of valuation and verification are consistently applied from year to year. Any change in method should be properly justified and disclosed.
12. **Proper Audit Documentation :** All verification procedures performed, evidence obtained, and conclusions reached should be properly documented in audit working papers. These records serve as proof of the auditor's diligence and support the audit opinion.
13. **Compliance with Legal and Statutory Requirements :** The auditor must ensure that verification complies with relevant legal provisions, accounting standards, and regulatory requirements. Any non-compliance should be reported appropriately.

Observing these precautions ensures that verification of assets and liabilities is carried out effectively and reliably. By exercising due care, professional judgement, and independence, the auditor can ensure that the balance sheet presents a of the financial position of the business and safeguards the interests of stakeholders.

Recap

- ◊ Vouching is the process of checking accounting entries with supporting documents to ensure that transactions are genuine and correctly recorded.
- ◊ A voucher is documentary evidence (such as an invoice, receipt, or bill) that supports and proves a recorded transaction.
- ◊ Verification is the process of confirming the existence, ownership, and correctness of assets and liabilities shown in the balance sheet.
- ◊ Vouching checks the accuracy of transactions recorded in books, whereas verification confirms the existence and ownership of assets and liabilities.
- ◊ Valuation of assets means determining the correct monetary value of assets to be shown in the balance sheet as per accounting principles.
- ◊ Valuation of liabilities refers to determining the correct amount payable by the business and showing it accurately in the balance sheet.
- ◊ Verification establishes the existence and ownership of assets and liabilities, while valuation determines their correct financial value.
- ◊ Ensure that vouchers and balances are genuine, properly authorized, correctly valued, and completely recorded without over- or under-statement.

Objective Questions

1. What is the process of checking accounting entries with supporting documents?
2. What do we call the documentary evidence supporting a transaction?
3. What is the process of confirming existence and ownership of assets and liabilities?
4. What determines the monetary value of assets in the balance sheet?
5. What ensures assets and liabilities are shown at correct amounts?
6. Which process focuses on examining source documents of transactions?
7. Which process confirms assets physically or through records?
8. What principle helps maintain uniformity in asset valuation over years?

Answers

1. Vouching
2. Voucher
3. Verification
4. Valuation
5. Valuation
6. Vouching
7. Verification
8. Consistency

Self-Assessment Questions

1. What is a Voucher? State any four types of vouchers.
2. Explain the meaning of Verification of assets.
3. Distinguish between Vouching and Verification.
4. What is meant by Valuation of assets and liabilities?
5. Explain Vouching in detail.
6. Distinguish between Valuation and Verification in detail.
7. Explain the valuation of assets and liabilities. Discuss the principles to be followed while valuation.
8. Explain the precautions to be taken by an auditor while verifying and valuing assets and liabilities.

Assignments

1. Visit a nearby shop or small business and list the types of vouchers used for recording daily transactions.
2. Assume you are an auditor of a trading firm how would you verify the existence of cash, stock, and furniture?
3. Take a case of machinery in a factory and explain how it should be valued for the balance sheet.
4. Identify any three liabilities of a business and explain how you would verify and value them.
5. Explain with an example how overvaluation of assets can mislead business decisions.
6. Choose a business of your choice and list the precautions an auditor should take while verifying its assets.
7. Explain how outstanding expenses and contingent liabilities are identified and disclosed in practice.
8. Prepare a brief report showing the difference between vouching and verification using a real-world business example.

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Unit 2

Audit Report

Learning Outcomes

After completing this unit, the learner will be able to:

- ◊ develop an awareness of the audit report
- ◊ familiarize themselves with the contents of an audit report
- ◊ explain the qualifications in audit reports
- ◊ gain insight into the different types of audit reports

Prerequisite

At the end of the financial year, Sunrise Textiles Ltd. proudly announced that its accounts were complete and ready to be shared with shareholders. The management believed the numbers truly reflected the company's performance, but investors, banks, and regulators had one important question: Can we trust these figures? To answer this, an independent auditor examined the books, verified evidence, and evaluated whether accounting rules were properly followed. After completing this examination, the auditor prepared a formal written statement expressing an opinion on the truth and fairness of the financial statements. This document, known as the Audit Report, becomes the final voice of the auditor and the bridge of confidence between the company and all those who rely on its financial information.

Keywords

Audit report, clean report, qualified opinion

Discussion

An audit report is a formal document issued by an auditor after examining a company's financial statements, accounting processes, and internal control systems. Its primary objective is to provide stakeholders with a clear and reliable view of the company's financial position, highlight any significant issues identified during the audit, and present the auditor's opinion on the accuracy and fairness of the financial records.

5.2.1 Introduction to an Audit Report

An audit report provides stakeholders with a professional opinion on whether the company's financial statements present a true and fair view and are prepared in accordance with applicable accounting standards. It is used by various parties such as investors, management, government authorities, and banks to assess the reliability of the financial information. This opinion helps them decide whether they can place confidence in the company's financial reports.

Audit reports are generally issued by external auditors who are independent of the organisation. This independence enables auditors to provide an objective and unbiased opinion. In some cases, companies also prepare internal audit reports through their own audit staff to review internal processes more frequently and ensure operational efficiency and compliance.

5.2.1.1 Contents of an Audit Report

1. **Title :** The auditor's report shall have a title that clearly indicates that it is the report of an independent auditor.
2. **Addressee :** The auditor's report shall be addressed appropriately based on the circumstances of the engagement. Law, regulation, or the terms of engagement may specify to whom the report should be addressed. Generally, the report is addressed to those for whom it is prepared, most commonly the shareholders or those charged with governance of the entity. In the case of a company, the report is normally addressed to the shareholders.
3. **Introduction :** This section identifies the entity whose financial statements have been audited, specifies the financial period covered by the audit, and lists the financial statements that were examined.
4. **Scope of the Audit :** This section describes the nature of the audit procedures performed and outlines the scope of the auditor's examination.
5. **Auditor's Opinion :** This is the most important section of the audit report. It states the auditor's opinion on whether the financial statements present a true and fair view of the company's financial position and performance, in all material respects, in accordance with the applicable accounting standards.
6. **Basis for Opinion :** The auditor's report shall include a section titled "Basis for Opinion", placed immediately after the Opinion section. This section:

- States that the audit was conducted in accordance with the Standards on Auditing.
- Refers to the section of the report describing the auditor's responsibilities.
- Confirms that the auditor is independent of the entity in accordance with relevant ethical requirements and has fulfilled all other ethical responsibilities.
- States whether the auditor believes that sufficient and appropriate audit evidence has been obtained to provide a basis for the opinion.

7. **Key Audit Matters :** For audits of complete sets of general-purpose financial statements of listed entities, the auditor shall communicate key audit matters in the audit report. Where required by law or regulation, or where the auditor chooses to do so, key audit matters may also be communicated for entities other than listed entities.
8. **Responsibilities of Management and Those Charged with Governance :** Management is responsible for the preparation and fair presentation of the financial statements. This includes selecting and applying appropriate accounting policies consistently and maintaining adequate internal controls to prevent and detect fraud and errors. Those charged with governance, such as the board of directors, are responsible for overseeing the financial reporting process. They ensure that management performs its duties effectively and may appoint an audit committee to supervise the audit process.
9. **Auditor's Responsibilities for the Audit of the Financial Statements :** The auditor's report shall include a section titled "Auditor's Responsibilities for the Audit of the Financial Statements". This section explains:
   - The objectives of the auditor
   - That reasonable assurance represents a high level of assurance but is not a guarantee
   - That misstatements may arise due to fraud or error
10. **Signature of the Auditor :** The audit report shall be duly signed. The report is signed in the personal name of the auditor. Where an audit firm is appointed, the report is signed both in the name of the auditor and the audit firm.
11. **Date :** The date on which the audit report is issued.

5.2.2 Qualifications in Audit Reports

A qualification in an audit report is a statement by the auditor indicating a significant limitation or exception to the audit opinion. Such qualifications may arise due to several reasons, including:

◊ **Material Misstatements :** When the auditor identifies material misstatements in the financial statements that are not pervasive, a qualified opinion may be issued. This indicates that the financial statements present a true and fair view in all material respects, except for the specific areas affected by the misstatements.

◊ **Uncertainty :** If there is a significant uncertainty that may materially affect the financial statements, the auditor may issue a qualified opinion. For example, where there is a pending legal case with a potentially significant outcome, the auditor may qualify the opinion until the uncertainty is resolved.

5.2.2.1 Types of Qualifications

◊ **Scope Limitation :** A scope limitation arises when the auditor is unable to obtain sufficient and appropriate audit evidence relating to a material portion of the financial statements. In such circumstances, the auditor may issue either a qualified opinion or a disclaimer of opinion, depending on the severity of the limitation. Scope limitations may occur due to restrictions imposed by management or because of circumstances beyond the company's control, such as loss of records or practical constraints.

◊ **Departure from Generally Accepted Accounting Principles (GAAP) :** This type of qualification arises when the company fails to comply with Generally Accepted Accounting Principles or applicable accounting standards in a material manner. Such departures may affect the reliability and comparability of the financial statements and require disclosure in the audit report.

◊ **Uncertainty :** Uncertainty exists when there is a significant unresolved matter that could materially affect the financial statements. Examples include pending legal disputes, unresolved tax matters, or significant contingent liabilities. When such uncertainties are not adequately disclosed or resolved, the auditor may issue a qualified opinion.

5.2.2.2 Impact of Qualifications

A qualified audit opinion can significantly affect the credibility of a company's financial statements. Investors, creditors, and other stakeholders may be hesitant to rely on financial information that carries qualifications, as it indicates the presence of material issues or limitations identified during the audit.

It is essential for users of financial statements to understand the nature of the qualification and assess its potential impact on the company's financial performance and financial position. Qualifications may influence investment decisions, lending terms, and the overall perception of the company's reliability.

A qualification in an audit report is a serious matter and should not be ignored. It highlights a significant limitation or exception to the auditor's opinion and can materially affect the level of confidence stakeholders place in the financial information presented.

5.2.3 Types of Audit Reports

An audit report is a formal statement issued by an independent auditor after examining a company's financial statements, accounting records, and internal control systems. This report plays a crucial role for stakeholders such as investors, regulatory authorities, lenders, and management, as it provides an independent assessment of the company's financial position and compliance with accounting standards.

The audit report typically concludes with the auditor's opinion on whether the financial statements present a true and fair view of the company's financial position and performance. There are four main types of audit reports, each reflecting a different level of assurance and reliability: unqualified, qualified, adverse, and disclaimer of opinion.

5.2.3.1 Unqualified Opinion (Clean Report)

An unqualified opinion, commonly referred to as a clean report, is the most favourable type of audit opinion a company can receive. In this report, the auditor states that the financial statements are presented fairly, in all material respects, and are prepared in accordance with the applicable accounting standards, such as Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS).

A clean report indicates that the auditor has not identified any material misstatements or significant issues and believes that the company's financial records accurately reflect its financial position and performance.

An unqualified opinion provides a high level of confidence to investors and other stakeholders, as it demonstrates transparency, reliability, and sound financial reporting practices. It also enhances the company's reputation and may make it easier to obtain loans or attract new investors. For management, a clean report confirms the effectiveness of internal controls and accounting systems, contributing to business stability and long-term growth.

5.2.3.2 Qualified Opinion

A qualified opinion is issued when the auditor concludes that the financial statements are generally reliable but contain a specific material issue that does not comply with accounting standards. In such cases, the auditor expresses a qualified opinion, clearly describing the nature of the exception in a separate explanatory paragraph.

Common reasons for issuing a qualified opinion include scope limitations, where the auditor is unable to obtain sufficient audit evidence in a particular area, or deviations from standard accounting practices that affect only certain aspects of the financial statements.

For example, if inventory records are incomplete or a particular revenue recognition method does not comply with GAAP, the auditor may issue a qualified opinion. While this does not indicate that the entire set of financial statements is unreliable, it alerts stakeholders to a specific concern that requires attention.

Although a qualified opinion may raise caution, it still allows stakeholders to rely on most aspects of the financial statements. It represents a moderate level of assurance, indicating that the company is largely compliant with accounting standards but has identifiable and correctable issues.

5.2.3.3 Adverse Opinion

An adverse opinion is the most serious type of audit opinion and is issued when the auditor determines that the financial statements contain material and pervasive misstatements. In such cases, the financial statements do not present a true and fair view and are not prepared in accordance with applicable accounting standards.

An adverse opinion suggests that the financial information may mislead stakeholders and could indicate serious issues such as fraud, ineffective management, or severe weaknesses in internal controls.

Receiving an adverse opinion can have serious consequences for a company, including loss of investor confidence, difficulty in raising finance, and increased regulatory scrutiny. Management must take immediate corrective action to address the issues identified and restore credibility. In cases involving deliberate misrepresentation or fraud, legal consequences may also arise.

For investors and creditors, an adverse opinion serves as a strong warning signal, indicating a high level of financial risk. Companies receiving such opinions must act promptly to rectify deficiencies and prevent long-term damage to their business reputation.

5.2.3.4 Disclaimer of Opinion

A disclaimer of opinion is issued when the auditor is unable to express any opinion on the financial statements. This occurs when the auditor cannot obtain sufficient and appropriate audit evidence due to significant limitations, such as lack of access to essential records, inadequate documentation, or major uncertainties affecting the financial information.

For example, if management restricts access to key financial records or fails to provide necessary explanations, the auditor may be forced to disclaim an opinion. Similarly, unresolved legal disputes or major contingent liabilities may prevent the auditor from forming a reliable conclusion.

A disclaimer of opinion indicates serious concerns regarding transparency, record-keeping, or cooperation with the auditor. For stakeholders, it raises substantial doubts about the reliability of the financial statements and may lead to reduced investor confidence, reluctance from lenders, and increased regulatory attention. Companies receiving a disclaimer should take immediate steps to address the underlying issues and ensure improved financial reporting and auditability in the future.

Recap

- ◊ The auditor's opinion is the most critical part of the audit report.
- ◊ A qualification is a statement by the auditor that indicates a significant limitation or exception in the audit.
- ◊ An unqualified opinion is also known as a clean report and indicates that the financial statements present a true and fair view.
- ◊ A qualified opinion states that the financial statements are generally accurate but contain a specific area that does not conform to accounting standards.
- ◊ An adverse opinion indicates that the company's financial statements are not accurate or reliable.
- ◊ A disclaimer of opinion is issued when the auditor is unable to express an opinion on the company's financial statements.

Objective Questions

1. What does an audit report assess?
2. What is an Unqualified Opinion also known as?
3. What does a Disclaimer of Opinion mean?
4. Which audit opinion indicates severe financial misstatements?
5. What type of opinion suggests minor issues but overall reliability in f inancial statements?
6. Which type of opinion would indicate the highest level of investor confidence?
7. In which type of opinion does the auditor provide a "clean bill of health"?
8. Which section of an audit report gives the final opinion on the financial statements

Answers

1. The accuracy and reliability of a company's financial statements
2. Clean Report
3. The auditor cannot form an opinion due to lack of information
4. Adverse Opinion
5. Qualified Opinion 6. Unqualified Opinion
6. Unqualified Opinion
7. Opinion

Self Assessment Questions

1. What is the primary purpose of an audit report, and why is it important for investors?
2. What does an Unqualified Opinion (Clean Report) signify in an audit report, and why is it considered the most favourable opinion?
3. What is a Qualified Opinion, and how does it differ from an Adverse Opinion? Give an example of a situation in which a company might receive a qualified opinion.
4. What is a Disclaimer of Opinion, and under what circumstances might an auditor issue this type of report?
5. How can an Adverse Opinion affect a company's relationship with its stakeholders and investors?
6. What are the main sections of a typical audit report, and what is the purpose of each section?
7. What information is included in the Scope of the Audit section, and why is it important for users of the audit report?
8. Why might an auditor issue a qualified opinion instead of an unqualified opinion, and how does this affect the perceived accuracy of the financial statements?
9. How does the Basis for Opinion section support the auditor's conclusions, and why is it important for ensuring transparency in an audit report?

Assignments

1. Select a company that has received an Adverse Opinion in its audit report in recent years. Summarise the reasons for the adverse opinion, explain how the company responded, and analyse the impact on its stock price and investor confidence. Evaluate how this audit opinion affected the company's financial position and reputation.
2. Prepare a detailed report explaining the contents of an audit report. Describe the purpose of each section, including the Title, Opinion, Scope of the Audit, Basis for Opinion, and any other relevant sections. Explain how each section contributes to the overall transparency and reliability of the audit report.
3. Compare and contrast an Unqualified Opinion and a Qualified Opinion. Explain the circumstances that lead to each type of opinion, how each is presented in the audit report, and how they may influence a potential investor's decision.
4. Assume the role of an auditor for a mid-sized business that has minor financial discrepancies requiring disclosure but not severe misstatements. Prepare a mock audit report presenting a Qualified Opinion. Include the main sections of an audit report and clearly explain the findings in each section.
5. Write an in-depth report on the various types of qualifications in audit reports. Describe situations in which a company may receive a qualified opinion and explain how such qualifications affect the interpretation of the financial statements.
6. Create a fictional company scenario in which certain financial records are missing. Based on this scenario, determine whether a Disclaimer of Opinion or a Qualified Opinion should be issued, and justify your decision with appropriate reasoning.

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6 BLOCK

Forensic Audit

Unit 1
Introduction to Forensic Audit

Learning Outcomes

After completing this unit, the learner will be able to:

- ◊ comprehend the concept of Fraud
- ◊ discuss the concept of forensic audit
- ◊ describe the impact of corporate fraud
- ◊ aware the investigation mechanism to identify frauds

Prerequisite

In a small textile town of Surat, a well-known family-owned fabric trading firm, Shree Ganesh Textiles, was growing rapidly. Orders were increasing, bank loans were approved easily, and the owners trusted their accounts manager completely. Every month, the books showed healthy profits, yet the firm was always short of cash. Salaries were delayed, suppliers complained, and loan repayments began to slip.

Suspecting that something was wrong, the partners first asked their regular auditor to check the accounts. The audit report showed that the records were properly maintained and followed accounting rules. Still, the cash problem continued. Finally, the bank, worried about its loan exposure, appointed a special team to investigate the matter in detail.

This team did not just check vouchers and totals. They traced money flows, compared bank statements with sales records, studied emails, examined computer data, and even looked into personal accounts linked to the firm. After careful examination, they discovered that fake purchase bills were created and payments were quietly diverted to shell accounts controlled by the accounts manager. This detailed investigation, aimed at detecting fraud, collecting evidence, and identifying the guilty party, is known as a Forensic Audit. Unlike a routine audit, a forensic audit goes deeper, works like an investigation, and its findings can be used in courts, banks, and legal proceedings.

Keywords

Fraud, forensic audit, corporate frauds

Discussion

In a busy housing development project in Pune, a construction company, Greenview Builders, was completing its final phase of flats. Buyers had paid most of the amount, and the project appeared successful on paper. However, delays in construction and repeated requests for additional funds raised doubts among the investors. When the directors reviewed the accounts, everything looked normal. Bills were properly filed, payments were authorised, and the regular audit showed no major errors. Still, the actual progress on the site did not match the money spent. Cement and steel purchases were unusually high, yet the buildings were incomplete.

On closer observation, it was found that some bills were deliberately overstated and a few suppliers existed only on paper. Money was being intentionally misrepresented and misused for personal gain. This deliberate act of deception to gain an unfair benefit is known as fraud. To uncover the truth, the company appointed specialists who treated the case like an investigation rather than a routine check. They examined contracts, traced fund movements, verified suppliers physically, analysed digital records, and gathered evidence that could stand in a court of law. This specialised examination of financial records, carried out to detect fraud and establish facts with legal proof, is called a forensic audit.

Through this story, fraud can be understood as intentional deception, and forensic audit as the systematic investigation designed to detect, analyse, and prove such deception.

6.1.1 Fraud

Fraud is one of the most serious ethical and legal issues affecting business, finance, and public administration. It weakens trust, distorts financial information, and causes significant losses to organisations, investors, governments, and society at large. In accounting and auditing, understanding the meaning and nature of fraud is essential because fraud is intentional, concealed, and often difficult to detect through routine checks.

In simple terms, fraud refers to a deliberate act of deception carried out with the intention of gaining an unfair or unlawful advantage. Unlike errors, which occur unintentionally due to mistakes or oversight, fraud is planned and executed knowingly. It usually involves misrepresentation, concealment of facts, falsification of records, or abuse of position for personal or organisational gain.

From a legal perspective, Black's Law Dictionary, a widely recognised authoritative source, defines fraud as "an intentional perversion of truth for the purpose of inducing another to part with something of value or to surrender a legal right." This definition clearly highlights three essential elements of fraud: intention, deception, and loss to another party. Without intention and dishonesty, an act cannot be classified as fraud.

In the field of accounting and auditing, professional bodies have also provided clear definitions. The Institute of Chartered Accountants of India (ICAI) defines fraud as "an intentional act by one or more individuals, involving the use of deception to obtain an unjust or illegal advantage." This definition emphasises that fraud may be committed by employees, management, or even external parties, and it always involves dishonest intent.

Similarly, the Association of Certified Fraud Examiners (ACFE) explains fraud in an organisational context as "the use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the employing organisation's resources or assets." This definition draws attention to occupational fraud, where individuals exploit their position of trust to commit wrongdoing.

Fraud can take many forms, such as manipulation of accounts, creation of fake invoices, misappropriation of cash, falsification of financial statements, bribery, or suppression of material information. In all cases, the common feature is intentional deception aimed at deriving benefit and causing loss to others. Because fraud is usually concealed carefully, it may remain undetected for long periods and cannot always be identified through ordinary auditing procedures.

fraud is a deliberate, dishonest act involving deception and misuse of information or authority for unfair gain. Its intentional nature distinguishes it clearly from errors and negligence. Due to its complexity and legal implications, fraud often requires specialised investigation methods, leading to the growing importance of forensic auditing in modern business and governance.

As fraud involves deliberate concealment and manipulation of financial information, it often remains hidden from routine audits and internal checks. This limitation creates the need for a specialised approach that goes beyond verifying figures and compliance. **Forensic audit** emerges as this advanced mechanism, combining accounting knowledge with investigative and legal techniques to detect, analyse, and establish evidence of fraud. Thus, forensic auditing acts as the vital link between the occurrence of fraud and its detection, investigation, and legal resolution.

6.1.2 Forensic audit

In the modern business environment, the increasing complexity of financial transactions and the rise in fraudulent activities have created the need for specialised methods of investigation. Traditional audits are mainly concerned with verifying the accuracy and fairness of financial statements, but they are not designed to uncover deliberate deception. In such situations, the role of a forensic audit becomes crucial.

The term forensic audit refers to a detailed examination of financial records with the specific purpose of detecting fraud, identifying financial irregularities, and collecting evidence that can be used in legal proceedings. The word forensic means “related to courts or law”, indicating that the findings of such an audit are suitable for presentation before judicial or regulatory authorities.

According to the Institute of Chartered Accountants of India (ICAI), a forensic audit is “an examination and evaluation of a firm’s or an individual’s financial information for use as evidence in court.” Similarly, the Association of Certified Fraud Examiners (ACFE) defines forensic auditing as “the application of accounting skills to investigate fraud or embezzlement and to analyse financial information for use in legal proceedings.” These definitions clearly highlight that a forensic audit combines accounting knowledge with investigative and legal skills.

Unlike a routine audit, a forensic audit is conducted with a questioning and investigative approach. The auditor does not assume that records are correct but actively looks for signs of manipulation, concealment, or misuse of funds. Techniques such as tracing money trails, analysing bank statements, verifying the existence of suppliers and customers, examining electronic records, and reviewing contracts and emails are commonly used.

Figure 6.1.1 Forensic audit

For example, a company may report high profits in its financial statements while facing persistent cash shortages. A forensic audit may reveal that sales figures were inflated by recording fictitious customers, thereby misleading stakeholders. In another case, a bank may suspect that a borrower has misused loan funds. Through a forensic audit, the flow of funds can be traced, revealing that the loan amount was diverted to personal accounts instead of being used for business purposes. Similarly, in public sector organisations, forensic audits often uncover fake bills, non-existent suppliers, and inflated project costs.

a forensic audit is a systematic and investigative examination of financial information conducted with the objective of detecting fraud and producing legally acceptable evidence. It serves as a vital tool in combating financial crimes, ensuring accountability, and strengthening trust in financial systems. As fraud becomes more sophisticated, the importance of forensic auditing continues to grow in both the corporate and public sectors.

6.1.2.1 Features of forensic audit

A **forensic audit** has certain distinctive features that differentiate it from a routine statutory audit. These features reflect its investigative nature and its focus on fraud detection and legal evidence.

1. **Investigative Approach** : A forensic audit is conducted with a questioning and sceptical mindset. The auditor assumes the possibility of fraud and investigates financial records to uncover intentional wrongdoing.
2. **Focus on Fraud Detection and Prevention** : The primary objective of a forensic audit is to detect fraud, financial manipulation, and irregularities. It also helps organisations strengthen controls to prevent future frauds.
3. **Legal Orientation** : The findings of a forensic audit are suitable for use in courts, tribunals, and regulatory proceedings. Evidence is collected and documented in a legally acceptable manner.
4. **Evidence-Based Examination** : Emphasis is placed on gathering concrete evidence such as documents, bank records, digital data, emails, contracts, and transaction trails rather than relying only on accounting totals.
5. **Detailed and In-Depth Analysis** : A forensic audit involves a thorough examination of selected transactions rather than a general review. Suspicious transactions are analysed in depth to identify intent and responsibility.
6. **Use of Specialised Techniques** : Techniques such as data analysis, fund tracing, ratio analysis, trend analysis, and examination of electronic records are commonly used in forensic audits.
7. **Identification of Persons Responsible** : Unlike routine audits, a forensic audit seeks not only to identify fraud but also to establish who committed it, how it was committed, and the extent of loss involved.
8. **Confidential Nature** : Forensic audits are usually conducted confidentially to avoid alerting suspects and to preserve the integrity of evidence.
9. **Event-Based Audit :** " A forensic audit is generally undertaken when fraud is suspected, a dispute arises, or a complaint is received, rather than being a regular or periodic audit.

10. **Interdisciplinary Nature :** A forensic audit combines knowledge of accounting, auditing, law, investigation, information technology, and criminology.

The key features of a forensic audit lie in its investigative focus, legal relevance, evidence-based methodology, and its role in detecting and proving fraud. These features make forensic auditing an essential tool in combating financial crimes.

6.1.2.2 Significance of Forensic Audit

The significance of a **forensic audit** has increased considerably in recent years due to the growing incidence of fraud, financial crimes, and corporate scandals. It plays a vital role in ensuring transparency, accountability, and trust in financial systems.

1. **Detection of Fraud and Financial Irregularities** : Forensic audits help in identifying hidden frauds, misappropriation of funds, manipulation of accounts, and financial misconduct that may not be detected through routine audits.
2. **Legal Evidence and Litigation Support** : One of the most important significances of a forensic audit is that it provides evidence that is legally admissible. The findings can be used in courts, tribunals, and regulatory investigations.
3. **Prevention of Future Frauds** : The presence of forensic auditing acts as a deterrent. Employees and management are less likely to commit fraud when they know that specialised investigations can uncover wrongdoing.
4. **Protection of Stakeholders' Interests** : Forensic audits safeguard the interests of shareholders, investors, lenders, employees, and the government by exposing dishonest practices and ensuring accountability.
5. **Strengthening Corporate Governance** : By uncovering weaknesses in internal control systems, forensic audits help organisations improve governance, transparency, and ethical practices.
6. **Assistance in Dispute Resolution** : Forensic audits assist in resolving commercial disputes, partnership conflicts, insurance claims, and contract disagreements by establishing facts objectively.
7. **Recovery of Financial Losses** : By tracing fund movements and identifying responsible parties, forensic audits help organisations recover misappropriated assets and quantify losses accurately.
8. **Support to Regulatory and Investigative Agencies** : Forensic audit reports provide valuable inputs to regulatory bodies, banks, vigilance authorities, and law enforcement agencies in financial crime investigations.
9. **Enhancing Public Confidence** : In cases involving public funds or large corporations, forensic audits help restore public trust by ensuring transparency and fairness.
10. **Aid in Risk Management** : Forensic audits help organisations identify fraud-prone areas and design effective risk management and internal control systems.

The growing scale and complexity of business operations have led to an increase in financial misconduct within organisations. When unethical practices are carried out by those in positions of authority or trust, the impact is far-reaching, affecting shareholders, employees, lenders, and the economy as a whole. Such misconduct, carried out in the course of corporate activities, is known as corporate fraud. Understanding corporate fraud is essential to appreciate how misuse of power, manipulation of financial information, and abuse of organisational resources can distort decision-making and damage corporate credibility.

6.1.3 Corporate Fraud

Corporate frauds have emerged as a major challenge in the modern business world, particularly as organisations grow larger and financial transactions become more complex. When fraudulent activities are committed within a corporate setting by management, employees, or external parties in collusion, the consequences extend beyond financial loss and severely damage trust, reputation, and corporate governance. Understanding the meaning of corporate frauds and the mechanisms used to identify them is therefore essential.

Corporate fraud refers to deliberate and unlawful acts of deception carried out in the course of business activities with the intention of gaining undue advantage. Such frauds often involve manipulation of accounts, falsification of financial statements, misappropriation of assets, insider abuse, or suppression of material information. Unlike errors or inefficiencies, corporate frauds are intentional and carefully concealed.

To understand this concept clearly, consider the story of Malabar Aqua Exports, a medium-sized seafood export company based in Kochi, Kerala. The company had built a strong reputation in European markets and regularly reported rising profits. Encouraged by impressive financial statements, banks extended additional credit for expansion. However, despite showing healthy profits, the company faced frequent cash shortages and delayed payments to fishermen and suppliers.

Initially, the management attributed these issues to seasonal fluctuations. A routine audit was conducted and found no major irregularities, as all documents appeared properly authorised and recorded. However, when banks noticed inconsistencies between export volumes and foreign remittances, suspicion arose. This marked the beginning of a deeper investigation.

A specialised investigation team was appointed to analyse the situation. They traced export invoices, matched shipping bills with customs data, verified foreign currency receipts, and examined email communications. The investigation revealed that certain export sales were overstated, and remittances were partially diverted through overseas shell entities controlled by senior executives. This deliberate misrepresentation of financial performance and diversion of funds constituted a clear case of corporate fraud.

This story highlights why investigation mechanisms are crucial in identifying corporate frauds. Ordinary audits are designed to verify compliance and accuracy but may not uncover concealed dishonesty. Advanced mechanisms such as forensic audits, data analytics, fund flow analysis, verification of third parties, and examination of digital evidence play a key role in uncovering frauds. These mechanisms focus on intent, patterns of behaviour, and the trail of money rather than merely checking accounting entries.

Forensic audits, in particular, act as financial investigations. They combine accounting knowledge with legal and technological tools to gather evidence that can withstand judicial scrutiny. By identifying how the fraud was committed, who was responsible, and the extent of loss involved, forensic audits support legal action and recovery of funds.

Corporate frauds represent intentional abuse of corporate structures for personal or organisational gain. As illustrated through the example, such frauds can remain hidden behind impressive financial figures and routine audits. Effective investigation mechanisms, especially forensic auditing, are essential to detect, analyse, and prevent corporate frauds. Strengthening these mechanisms not only protects stakeholders but also reinforces ethical business practices and corporate accountability.

Case Study 1: Satyam Computer Services Scam (2009)

Satyam Computer Services, once a leading Indian IT company, was involved in one of India's biggest corporate frauds. The company's Chairman, Ramalinga Raju, admitted to manipulating the company's accounts for several years. Profits, cash balances, and bank statements were overstated to present a strong financial position and attract investors. In reality, the cash shown in the books did not exist. The fraud came to light when the management failed to justify fictitious balances, and forensic audits revealed forged bank confirmations and manipulated records. This case highlighted the importance of forensic auditing, strong corporate governance, and independent verification of financial statements.

Case Study 2: Punjab National Bank (PNB) Fraud – Nirav Modi Case (2018)

Punjab National Bank faced a major fraud involving jeweller Nirav Modi and his associates. The fraud was carried out through unauthorised Letters of Undertaking issued by bank officials without proper entries in the bank's core system. These guarantees were used to obtain loans from overseas branches of other banks. For years, the fraud went undetected due to weak internal controls and lack of system-based verification. The fraud was discovered during an internal review, followed by a forensic investigation that exposed collusion between bank staff and external parties. This case clearly shows how control failures and lack of monitoring can lead to large-scale corporate and banking frauds.

Case Study 3: Kingfisher Airlines Financial Misreporting Case

Kingfisher Airlines, promoted by Vijay Mallya, collapsed due to severe financial mismanagement and corporate fraud allegations. The company continued to report optimistic financial projections while accumulating huge losses and unpaid loans.

Funds borrowed from banks were diverted for purposes other than those sanctioned, including personal and group company expenses. Forensic investigations revealed misrepresentation of financial health, diversion of funds, and failure to disclose true liabilities. This case highlighted poor corporate governance, weak monitoring by lenders, and the importance of forensic audits in detecting fund diversion and financial misstatements.

Case Study 4: IL&FS Financial Crisis (2018)

Infrastructure Leasing & Financial Services (IL&FS) was a major infrastructure finance company in India. Despite mounting debt and liquidity stress, the company continued to show a stable financial position in its accounts. Complex group structures, delayed recognition of losses, and manipulation of cash flow reporting masked the true financial condition. The crisis came to light when IL&FS defaulted on its obligations, triggering a systemic shock. Forensic audits revealed governance failures, poor risk assessment, and misleading financial disclosures. This case underlined the need for transparency, timely reporting, and strong investigation mechanisms.

6.1.3.1 Investigation Mechanisms to Identify Corporate Frauds

Corporate frauds are usually well-planned, concealed, and executed over a period of time, making them difficult to detect through routine audits or standard internal controls. As corporate structures become more complex and transactions increasingly digital, the need for systematic and specialised investigative mechanisms has become critical. These mechanisms are designed not only to detect fraud but also to establish intent, identify responsible individuals, quantify losses, and collect evidence suitable for legal action.

One of the most important mechanisms for identifying corporate fraud is the forensic audit. Unlike statutory audits, which focus on compliance and fairness of financial statements, forensic audits adopt an investigative mindset. Forensic auditors examine selected transactions in depth, trace fund movements, analyse accounting patterns, and scrutinise supporting documents. For example, if a company reports high profits but faces continuous cash shortages, a forensic audit may reveal inflated sales through fictitious customers or premature revenue recognition.

Another crucial mechanism is fund flow and money trail analysis. Corporate fraud often involves diversion of funds through multiple accounts to hide their final destination. Investigators track the movement of money using bank statements, loan records, and payment data. In cases of loan fraud, this mechanism helps identify whether borrowed funds were used for the intended business purpose or diverted to personal accounts or unrelated entities.

Examination of books of accounts and supporting documents forms the foundation of fraud investigation. Investigators verify invoices, purchase orders, contracts, payroll records, and expense claims to detect fake bills, duplicate payments, inflated expenses, or forged documents. For instance, in procurement frauds, companies may record purchases from suppliers that exist only on paper, resulting in siphoning of funds.

With the widespread use of technology, digital and computer forensics has become an essential investigative tool. This mechanism involves analysing accounting software, emails, system logs, deleted files, and electronic records. Digital evidence often reveals manipulation of data, unauthorised access, or deliberate deletion of information. For example, altered timestamps or hidden spreadsheets may indicate intentional financial manipulation by senior employees.

Data analytics and financial ratio analysis are also widely used to identify red flags in corporate frauds. By comparing financial ratios across periods or with industry benchmarks, investigators can detect unusual trends such as abnormally high profit margins, sudden spikes in expenses, or inconsistent revenue growth. These analytical tools help narrow down areas requiring detailed investigation.

Physical verification and third-party confirmations play a vital role in establishing the authenticity of transactions. Investigators physically verify assets, inventory, and projects and obtain confirmations from customers, suppliers, banks, and lenders. In many corporate fraud cases, physical verification exposes non-existent assets or inflated stock values recorded in the books.

Another important mechanism is the use of interviews and interrogation techniques. Statements from employees, management, and external parties help investigators understand processes and identify inconsistencies. Skilled interviewing often reveals collusion, pressure from senior management, or deliberate concealment of information.

Whistle-blower mechanisms also serve as a powerful investigative trigger. Many large corporate frauds come to light due to information provided by insiders who notice unethical practices. A strong whistle-blower policy encourages early detection and supports effective investigation.

Finally, review of internal control systems and corporate governance practices helps investigators understand how fraud occurred and why it went undetected. Weak controls, lack of segregation of duties, and excessive management override often create an environment conducive to corporate fraud.

In conclusion, identifying corporate frauds requires a comprehensive and multi-layered investigative approach. No single mechanism is sufficient on its own. A combination of forensic audits, fund tracing, document examination, digital forensics, analytical tools, and human intelligence is essential to uncover frauds effectively. These investigative mechanisms not only help in detecting and proving corporate frauds but also contribute to strengthening governance and preventing future misconduct.

Case study: DHFL Bank Fraud Case – Forensic Audit Findings (2019)

Dewan Housing Finance Limited (DHFL) was investigated after allegations of fund diversion and fake loans emerged. A forensic audit uncovered thousands of fictitious home loan accounts and diversion of funds to related parties. The audit findings formed the basis for action by regulators and investigating agencies. This case showed how forensic audits can uncover deep-rooted financial manipulation in NBFCs.

Case study: Yes Bank Crisis – Forensic Review Impact (2020)

In the Yes Bank case, forensic reviews and audits identified under-reporting of non-performing assets, evergreening of stressed loans, and governance failures. The forensic findings helped regulators take timely corrective action, protect depositors, and restructure the bank. This case reflects the preventive and corrective role of forensic auditing in the Indian banking sector.

Recap

- ◊ Fraud is an intentional act of deception undertaken to obtain an unfair or unlawful financial benefit.
- ◊ Forensic audit is a specialised examination of financial records conducted to detect fraud and produce evidence for legal proceedings.
- ◊ Corporate fraud refers to dishonest or unethical practices carried out within an organisation to manipulate accounts or misuse corporate resources.
- ◊ Investigation mechanism to identify fraud is a systematic process of examining transactions, records, and controls to uncover and establish fraudulent activities.

Objective Questions

1. What involves intentional deception for personal or organisational gain is called?
2. The Indian professional body that defines and guides forensic auditing is?
3. The type of audit specifically conducted to detect fraud and gather legal evidence is?
4. The fraudulent case involving Satyam Computer Services occurred in which year?
5. The Nirav Modi case involved which Indian bank?
6. The airline company associated with financial misreporting and corporate fraud was?
7. The IL&FS crisis revealed failures in which type of corporate mechanism?

8. The type of fraud where employees misuse their position for personal enrichment is called?
9. Tracing fund movements and analysing money flow in fraud detection is known as?

Answers

1. Fraud
2. ICAI
3. Forensic
4. 2009
5. PNB
6. Kingfisher
7. Governance
8. Occupational
9. Fund flow

Self-Assessment Questions

1. Discuss the corporate frauds and famous 2 scams in India?
2. Explain the investigation mechanism to identify frauds?
3. Describe the Significance of forensic audit?
4. Briefly explain concept of forensic audit and its features?
5. Discuss the meaning of fraud ?

Assignments

1. Assess the nature and impact of corporate fraud in India by explaining how forensic audit helps in detecting and preventing such frauds in real business organisations.
2. Examine the major forms of corporate fraud commonly reported in Indian companies and evaluate the investigation mechanisms used to identify them in practice.
3. Analyse the role of forensic auditing in uncovering financial irregularities in Indian corporate houses with reference to practical investigation techniques.
4. Evaluate how weaknesses in internal control systems contribute to corporate fraud in India and assess the effectiveness of investigation mechanisms in controlling such frauds.
5. Critically assess the importance of forensic audit as a practical tool for identifying, investigating, and preventing corporate fraud in the Indian corporate environment.

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Unit 2

Cyber Forensics

Learning Outcomes

After completing this unit, the learner will be able to:

- ◊ comprehend the concept of cyber crime
- ◊ identify different types of cyber crimes
- ◊ gain knowledge about legal provisions related to cyber crimes
- ◊ get an overview of cyber forensics

Prerequisite

Late one Saturday morning in August 2018, customers of a well-known cooperative bank in Pune walked into ATMs across the city, only to find their accounts mysteriously drained. Some had not used their cards for days. Others were asleep when money was being withdrawn simultaneously from ATMs in India and abroad. By the time the bank officials realised something was wrong, crores of rupees had vanished within a few hours.

This was not a traditional bank robbery. No locks were broken, no alarms rang, and no employee was threatened. Instead, the attackers had quietly entered the bank's computer systems weeks earlier. Using malware, they compromised the bank's ATM switch server, which controls transaction authorisations. Once inside, they disabled security alerts and sent false approval signals. At the same time, cloned debit cards were used by an international network of criminals to withdraw cash from hundreds of ATMs across multiple countries.

For the bank, the challenge was not just financial loss but also understanding how the crime occurred. Transaction logs looked normal at first glance. Servers showed no obvious damage. Employees denied any wrongdoing. It was only through cyber forensic investigation that experts reconstructed the digital trail. They examined server logs, traced malware behaviour, analysed IP addresses, and correlated ATM timestamps across countries. This digital evidence revealed that the attack originated from outside India and involved coordinated actions across cyberspace. This incident marked one of India's most significant cyber-enabled financial crimes and highlighted a crucial reality of the modern world: crimes today are often invisible, borderless, and technology-driven. Traditional investigation methods alone are no longer sufficient. Understanding digital evidence, tracking cyber footprints, and preserving electronic data have become essential. This is where Cyber Forensics begins the science that uncovers hidden digital truths, reconstructs cybercrimes, and helps investigators answer the most critical question in the digital age: what really happened behind the screen?

Keywords

Cyber-Crimes, Legal Provisions, Cyber Forensics

Discussion

In May 2017, hospitals across the United Kingdom suddenly began cancelling surgeries, locking emergency rooms, and turning away patients. Doctors could not access medical records. Screens displayed a red warning demanding payment in Bitcoin. Within hours, the same attack spread to more than 150 countries, affecting telecom companies, railways, universities, and even ATMs. India was not spared organisations such as Andhra Pradesh Police and several private institutions reported system disruptions.

The attack was caused by WannaCry ransomware, a malicious software that exploited a vulnerability in Microsoft Windows systems. Once inside a computer network, the malware encrypted critical data and demanded ransom for its release. Victims did not lose money through theft alone; they lost access to essential digital information. The attackers never needed physical access to buildings or systems. A few lines of malicious code, transmitted through the internet, were enough to paralyse entire organisations.

Investigators later found that the ransomware used stolen cyber weapons originally developed for state surveillance, highlighting how powerful digital tools can be misused. The crime crossed national borders instantly, affected public safety, and targeted digital infrastructure itself. Evidence existed only in electronic form encrypted files, system logs, malware signatures, and network traffic.

This case clearly explains the concept of cyber- crime. The offence was unlawful, intentional, and executed through computers and networks. The computer systems were both the target (data encryption and system lockdown) and the tool (malware propagation). No traditional crime scene existed; the entire crime occurred in cyberspace.

Therefore, cyber- crime can be defined as any illegal act in which computers, digital devices, or networks are used as the primary tool, target, or place of offence. The WannaCry attack demonstrates that modern crimes are no longer limited by geography and that digital evidence and cyber forensic techniques are essential to investigate, attribute, and prosecute such offences.

6.2.1 Cyber - Crime

Cyber-crime refers to unlawful activities that are carried out using computers, mobile devices, digital networks, or the internet. In such crimes, technology is not just a supporting element but the main medium through which the offence is committed. Cyber- crime may involve stealing data or money, damaging computer systems, violating privacy, spreading malware, or disrupting online services. These crimes are often invisible, fast, and capable of crossing national boundaries within seconds.

Cyber-crime can be defined as any illegal act in which a computer, digital device, or network is used as a tool, a target, or both, to commit an offence.

Another commonly accepted definition states that cyber-crime is a crime that involves the use of information technology to gain unauthorised access, misuse data, or cause harm to individuals, organisations, or governments.

Case Study: Fake Social Media Profiles Scam (Kerala)

In Kerala, several cyber-crime cases have been reported where offenders created fake profiles on Facebook and Instagram using photographs and personal details of genuine individuals such as professionals, college students, or government employees. These photographs were usually taken from public social media accounts. The criminals carefully copied names, educational details, and even mutual friends to make the profiles appear authentic.

Once the fake profile was created, friend requests were sent to unsuspecting users. After gaining trust through regular online interaction, the criminals emotionally manipulated victims by pretending to be in distress, asking for urgent financial help, or offering overseas job opportunities, especially in Gulf countries. In many cases, victims transferred money through online banking, UPI, or digital wallets, believing they were helping a known person.

This crime involves identity theft because the offender unlawfully used another person's digital identity. It is also a form of online impersonation, as the criminal pretended to be someone else on a digital platform. The entire offence occurred online without any physical contact, making it a clear case of cyber-crime.

Case Study: Kerala Lottery Phishing Scam

The Kerala Lottery Phishing Scam is a common and recurring cyber fraud reported across the state. Victims received emails, SMS messages, or WhatsApp notifications claiming that they had won a Kerala Government Lottery prize. The message contained official-looking logos and language to create trust.

Victims were asked to click on a link to claim the prize. The link redirected them to a fake website designed to look like a government portal. On this site, victims were asked to enter personal details such as name, Aadhaar number, bank account details, debit card information, and OTPs. Once these details were entered, criminals immediately accessed the victim's bank account and withdrew money.

This crime is known as phishing, where victims are tricked into revealing confidential information through fake digital communication. It also amounts to online cheating, as deception was used to cause financial loss. Since the entire fraud was carried out using digital messages and fake websites, it qualifies as cyber-crime.

Case Study: Women Cyber Stalking Case (Kerala)

In several reported cases in Kerala, women were subjected to continuous online harassment through platforms such as WhatsApp, Instagram, Facebook, and email. Offenders repeatedly sent unwanted messages, threats, obscene content, and in some cases, morphed photographs to defame and intimidate victims.

The criminals often used fake profiles, temporary phone numbers, and anonymous email accounts to hide their identity. Victims experienced mental stress, fear, and reputational harm. Police investigations involved cyber forensic techniques such as tracing IP addresses, analysing call data records, device logs, and social media activity to identify the accused.

This offence is categorised as cyber stalking and cyber harassment. The crime occurred entirely in the digital space, using electronic communication tools, making it a clear case of cyber-crime under Indian cyber laws.

Case Study: Aadhaar Data Leak (India)

In 2018, media reports revealed that personal information linked to Aadhaar, including names, addresses, phone numbers, and Aadhaar numbers of millions of Indian citizens, was allegedly accessible through unauthorised websites and portals. Some portals reportedly allowed access in exchange for a small payment.

This incident raised serious concerns about data security and privacy. Aadhaar information is sensitive personal data, and unauthorised access or disclosure can lead to identity theft, financial fraud, and misuse of personal information.

This case represents a data breach and privacy violation, as confidential digital data was accessed and exposed without legal authorisation. Since the offence involved unauthorised access to electronic data stored in computer systems, it clearly falls under cyber crime.

Case Study: Gulf Job Scam (Kerala)

Kerala has witnessed numerous cases of online job fraud targeting unemployed youth seeking overseas employment. Fraudsters created fake recruitment websites and sent emails or social media messages offering attractive jobs in Gulf countries. These messages appeared professional and included fake company logos and appointment letters.

Victims were asked to pay registration fees, visa processing charges, or medical examination fees through online payment platforms. After receiving the money, the fraudsters disappeared, and the websites were taken down. Cyber investigations later traced fake domains, email servers, and digital payment trails.

This offence is classified as online job fraud, where deception is carried out using internet-based platforms. Since the fraud was executed entirely through digital means, it is a cyber-crime.

Case Study: WannaCry Ransomware Impact in India

In 2017, the global WannaCry ransomware attack affected several organisations in India, including government departments and private institutions. The malware entered computer systems through unpatched software vulnerabilities. Once infected, it encrypted important files and displayed a ransom message demanding payment in cryptocurrency to restore access.

The attack disrupted operations, caused data loss, and created panic. Digital forensic experts analysed malware behaviour, system logs, and network traffic to understand the attack and prevent further spread.

This case is classified as a malware attack and, in broader terms, cyber terrorism, as it targeted critical digital infrastructure. The attack was carried out using malicious code, making it a classic example of cyber-crime.

All these cases clearly demonstrate that cyber-crime involves illegal acts where computers, digital devices, networks, or data are used as the main tools or targets of crime. These crimes are technology-driven, often anonymous, and require specialised cyber forensic methods for investigation. And all these case leads o different types of cyber - crimes. following are the different types of cyber-crimes:

One of the most common types of cyber-crime is identity theft and online impersonation. In this form of crime, offenders unlawfully obtain personal information such as names, photographs, login credentials, or Aadhaar details and use them to impersonate victims on digital platforms. Fake social media profiles, email impersonation, and misuse of personal data are typical examples. Such crimes can lead to financial loss, reputational damage, and emotional distress for victims.

Another major category is phishing and online fraud. Phishing involves sending fraudulent emails, messages, or links that appear to come from trusted sources such as banks, government departments, or lottery offices. Victims are tricked into sharing sensitive information like passwords, bank details, and one-time passwords. Once the information is obtained, criminals misuse it to withdraw money or commit further fraud. Online cheating through fake websites and digital advertisements also falls under this category.

Cyber stalking and online harassment are a growing concern, especially with the widespread use of social media. This type of cyber-crime includes repeated unwanted messages, threats, defamation, circulation of morphed images, and online abuse. Victims, particularly women and minors, suffer psychological stress and fear due to continuous digital harassment. These offences are committed entirely through electronic communication platforms.

Banking and financial cyber-crimes involve illegal access to banking systems, unauthorised fund transfers, ATM fraud, credit card cloning, and online payment fraud. Cyber criminals use malware, hacking techniques, and stolen credentials to gain access to financial data. Such crimes can result in large-scale monetary losses and undermine trust in digital banking systems.

Data breach and privacy violation is another serious form of cyber-crime. It occurs when confidential and sensitive data stored in computer systems is accessed, disclosed, or leaked without authorisation. Personal data, health records, financial information, and government databases are common targets. Data breaches can lead to identity theft, misuse of personal information, and violation of individual privacy rights.

Online job fraud has become increasingly common with the rise of digital recruitment platforms. Criminals create fake job portals or send fraudulent emails offering attractive employment opportunities, often abroad. Victims are asked to pay registration or processing fees online, after which the offenders disappear. This form of cyber-crime exploits unemployment and trust in online communication.

A more advanced and dangerous category is malware attacks and ransomware. Malware refers to malicious software designed to damage, disrupt, or gain unauthorised access to computer systems. Ransomware encrypts data and demands payment for its release. Such attacks can cripple hospitals, government departments, and businesses, causing severe operational and financial damage.

At an extreme level, cyber terrorism targets critical infrastructure such as power grids, communication networks, banking systems, and defence installations. These attacks aim to create fear, disrupt public services, and threaten national security. Cyber terrorism represents the most serious threat in the cyber-crime spectrum.

Icyber-crimes have evolved alongside technological advancement and now affect individuals, organisations, and governments alike. The common feature across all types of cyber-crimes is the misuse of digital technology as a tool or target of crime. Preventing and controlling cyber-crimes requires strong legal frameworks, public awareness, cybersecurity measures, and effective cyber forensic investigation. As society becomes increasingly digital, understanding different types of cyber-crimes is essential for ensuring a safe and secure cyber environment.

6.2.2 Legal provisions for cyber crimes in India

The rapid expansion of digital technology, online banking, e-governance, and social media has significantly increased the incidence of cyber-crimes in India. Activities such as hacking, identity theft, online fraud, cyber stalking, data breaches, and cyber terrorism pose serious threats to individuals, organisations, and national security. To address these challenges, India has established a comprehensive legal framework that defines cyber offences, prescribes punishments, and provides remedies to victims. The Information Technology Act, 2000, along with relevant provisions of the Indian Penal Code, forms the backbone of India's cyber law regime. The following tables present the key legal provisions and corresponding punishments applicable to various cyber-crimes in India, offering a clear understanding of how the law regulates and penalises offences committed in cyberspace.

Table 6.2.1 Legal Provisions in India Dealing with Cyber Crimes

Act	**Section**	**Nature of Cyber Crime**	**Description / Applicability**
IT Act, 2000	Section 43	Unauthorised access	Accessing, downloading, copying, or damaging computer systems without permission
IT Act, 2000	Section 43A	Data protection failure	Compensation for failure to protect sensitive personal data by body corporates
IT Act, 2000	Section 65	Tampering with computer source code	Concealing, destroying, or altering computer source code
IT Act, 2000	Section 66	Computer-related offences	Dishonest or fraudulent acts involving computers (extends Section 43 offences)
IT Act, 2000	Section 66B	Receiving stolen computer resource	Dishonestly receiving stolen computer data or devices
IT Act, 2000	Section 66C	Identity theft	Fraudulent use of digital signatures, passwords, or unique identification
IT Act, 2000	Section 66D	Cheating by personation	Online cheating using fake profiles, phishing, and impersonation
IT Act, 2000	Section 66E	Violation of privacy	Capturing or publishing private images without consent
IT Act, 2000	Section 66F	Cyber terrorism	Acts threatening national security using computer resources
IT Act, 2000	Section 67	Obscene electronic content	Publishing or transmitting obscene material online

IT Act, 2000	Section 67A	Sexually explicit content	Publishing sexually explicit material electronically
IT Act, 2000	Section 67B	Child sexual content	Child pornography and online child exploitation
IT Act, 2000	Section 69	Interception and monitoring	Government powers to intercept digital information
IT Act, 2000	Section 70	Protected systems	Unauthorised access to critical information infrastructure
IT Act, 2000	Section 72	Breach of confidentiality	Disclosure of information without consent
IT Act, 2000	Section 72A	Disclosure in breach of contract	Disclosure of personal data causing wrongful loss or gain

Table 6.2.2 IPC Provisions Applied to Cyber Crimes

IPC Section	Cyber Crime Covered	Description
IPC 419	Online impersonation	Cheating by pretending to be another person
IPC 420	Online cheating and fraud	Dishonest inducement and financial fraud
IPC 463–465	Electronic forgery	Forgery of electronic records
IPC 468	Forgery for cheating	Fake documents or digital records for fraud
IPC 469	Online defamation	Defaming a person through digital means
IPC 354A	Online sexual harassment	Sexual harassment through electronic communication
IPC 354D	Cyber stalking	Repeated online harassment and surveillance
IPC 499	Online defamation	Publishing defamatory content online

Table 6.2.3 Punishments under the Information Technology Act, 2000

Section	Cyber Crime	Punishment
Section 43	Unauthorised access, data damage	Compensation up to ₹1 crore (civil liability)
Section 43A	Failure to protect sensitive data	Compensation to affected person
Section 65	Tampering with computer source code	Imprisonment up to 3 years or fine up to ₹2 lakh or both
Section 66	Computer-related offences	Imprisonment up to 3 years or fine up to ₹5 lakh or both
Section 66B	Receiving stolen computer resource	Imprisonment up to 3 years or fine up to ₹1 lakh or both
Section 66C	Identity theft	Imprisonment up to 3 years and fine up to ₹1 lakh
Section 66D	Cheating by personation (online fraud)	Imprisonment up to 3 years and fine up to ₹1 lakh
Section 66E	Violation of privacy	Imprisonment up to 3 years or fine up to ₹2 lakh or both
Section 66F	Cyber terrorism	Imprisonment for life
Section 67	Publishing obscene content	Up to 3 years + ₹5 lakh (first offence); 5 years + ₹10 lakh (subsequent)
Section 67A	Sexually explicit content	Up to 5 years + ₹10 lakh (first offence)
Section 67B	Child sexual content	Up to 5 years + ₹10 lakh (first offence)
Section 70	Accessing protected systems	Imprisonment up to 10 years and fine
Section 72	Breach of confidentiality	Imprisonment up to 2 years or fine up to ₹1 lakh or both
Section 72A	Disclosure of data causing loss	Imprisonment up to 3 years or fine up to ₹5 lakh or both

Table 6.2.4 Punishments under the Indian Penal Code (IPC) Applied to Cyber Crimes

IPC Section	Cyber Crime	Punishment
IPC 419	Online impersonation	Imprisonment up to 3 years or fine or both
IPC 420	Online cheating and fraud	Imprisonment up to 7 years and fine
IPC 463–465	Electronic forgery	Imprisonment up to 2 years or fine or both
IPC 468	Forgery for cheating	Imprisonment up to 7 years and fine
IPC 469	Online defamation	Imprisonment up to 3 years and fine
IPC 354A	Online sexual harassment	Imprisonment up to 3 years or fine or both
IPC 354D	Cyber stalking	First offence: up to 3 years; subsequent: up to 5 years
IPC 499–500	Online defamation	Imprisonment up to 2 years or fine or both

6.2.3 International Laws Related to Cyber Crimes

The growth of the internet and digital technology has transformed cyber space into a global domain without physical boundaries. Cyber-crimes such as hacking, identity theft, ransomware attacks, cyber terrorism, and online fraud often originate in one country and affect victims in several others simultaneously. This borderless nature of cyber-crime makes national laws alone insufficient. As a result, international cooperation and global legal frameworks have become essential to prevent, investigate, and prosecute cyber-crimes effectively.

Cyber-crimes differ from traditional crimes because digital evidence can be stored anywhere in the world, offenders may operate anonymously, and attacks can be executed remotely. Jurisdictional conflicts, lack of uniform laws, and difficulties in evidence sharing make cyber-crime investigation complex. Therefore, international cyber laws aim to harmonise legal definitions, promote cooperation among nations, and establish common standards for cyber security and criminal justice.

1. Budapest Convention on Cybercrime (2001)

The Budapest Convention, officially known as the Convention on Cybercrime, is the first and most important international treaty addressing cyber-crimes. Adopted by the Council of Europe, it has been signed by many countries across the world, including the USA, UK, Japan, and Australia.

The Convention focuses on:

◊ Offences against computer systems and data

◊ Computer-related fraud and forgery

◊ Content-related offences

◊ International cooperation and mutual legal assistance

It encourages countries to criminalise acts such as illegal access, data interference, system interference, and misuse of devices.

If a hacker in one country illegally accesses a banking server in another country, the Convention enables cooperation between law enforcement agencies to trace the offender and collect digital evidence.

Case Law: In United States v. Ivanov (2001), a Russian hacker was charged in the USA for hacking US-based servers. The case highlighted the relevance of international cooperation principles promoted by the Budapest Convention.

2. United Nations Initiatives on Cyber Crime

The United Nations has played a significant role in recognising cyber-crime as a global threat. The UN General Assembly has passed several resolutions encouraging member states to strengthen cyber security and criminal laws related to information technology.

The United Nations Office on Drugs and Crime (UNODC) assists countries in:

◊ Drafting cyber-crime laws

◊ Building cyber forensic capacity

◊ Enhancing international cooperation

UNODC supports developing countries in setting up cyber-crime investigation units and training digital forensic experts.

3. INTERPOL and Cyber Crime Control

INTERPOL acts as a global coordination agency for cyber-crime investigations. It facilitates:

◊ Information sharing

◊ Digital intelligence analysis

◊ Joint international cyber-crime operations

INTERPOL's Global Cybercrime Programme helps countries respond to large-scale cyber-attacks such as ransomware and financial fraud. INTERPOL has coordinated international operations against online payment fraud networks and darknet marketplaces. The takedown of international cyber fraud gangs operating across Asia and Europe demonstrates INTERPOL's role in cyber-crime enforcement.

4. European Union Cyber Crime Laws

The European Union has developed strong legal mechanisms to address cyber-crimes and data protection.

a. **EU Cybercrime Directive** : This directive mandates member states to criminalise attacks against information systems, including hacking and malware attacks.

b. **General Data Protection Regulation (GDPR) :** GDPR protects personal data and imposes heavy penalties for data breaches and misuse of personal information.

Example: Companies leaking user data due to poor cyber security practices face massive fines under GDPR.

Case Law: In *Google LLC v. CNIL (2019)*, the Court of Justice of the EU examined data protection and privacy rights in the digital space, reinforcing strict compliance requirements.

5. International Cyber Terrorism Laws

Cyber terrorism involves attacks on critical infrastructure such as power grids, communication systems, defence networks, and financial institutions. Though no single global treaty exists exclusively for cyber terrorism, international conventions on terrorism and security are increasingly being extended to cover cyber-attacks.

Example: The WannaCry ransomware attack affected critical infrastructure across multiple countries, highlighting the need for global cyber security cooperation.

Case Reference: Investigations into WannaCry involved multiple nations sharing digital forensic intelligence.

6. Mutual Legal Assistance Treaties (MLATs)

MLATs allow countries to formally request assistance in cyber-crime investigations. These treaties are crucial for:

◊ Obtaining electronic evidence

◊ Extraditing cyber criminals

◊ Sharing investigation data

Example: India uses MLATs with the USA and European nations to obtain data from social media companies during cyber-crime investigations.

Despite the existence of international frameworks to combat cyber-crimes, effective enforcement of international cyber laws remains a significant challenge. One major difficulty arises from differences in national cyber laws, as countries vary widely in how they define cyber offences and prescribe punishments. Jurisdictional conflicts further complicate enforcement because cyber-crimes often originate in one country while affecting victims in another, making it unclear which nation has legal authority. The lack of universal acceptance of international treaties also weakens global cooperation, as some countries have not signed or ratified major conventions on cyber-crime. In addition, rapid technological change enables cyber criminals to adopt new methods faster than laws can be updated. As a result, limited harmonisation of legal systems and uneven international participation continue to restrict effective global action against cyber-crimes.

Cyber-crimes pose a serious global threat that cannot be addressed by national laws alone. International legal frameworks such as the Budapest Convention, UN initiatives, INTERPOL cooperation, and regional regulations like GDPR play a crucial role in combating cyber-crimes. These laws promote cooperation, harmonise legal standards, and strengthen cyber forensic investigations. As cyber threats continue to evolve, stronger international collaboration and updated legal mechanisms are essential to ensure security, justice, and trust in the digital world.

From the growing complexity of cyber-crimes and the challenges of enforcing cyber laws across borders, it becomes clear that legal provisions alone are not sufficient to combat offences committed in the digital world. When crimes leave no physical traces and exist only in the form of data, messages, logs, and electronic records, investigators must rely on scientific methods to uncover the truth. Identifying the source of an attack, preserving digital evidence without alteration, reconstructing events in cyberspace, and presenting reliable electronic proof before courts require specialised knowledge and tools. This critical need leads directly to the field of Cyber Forensics, which serves as the bridge between cyber-crime, law enforcement, and the justice system by systematically analysing digital evidence to reveal what actually happened in the virtual environment.

6.2.4 Cyber forensics

Late one evening, a young software professional in Kochi noticed that confidential office files stored on her laptop had suddenly disappeared. At the same time, her bank account showed unauthorised transactions, and threatening emails began appearing in her inbox. There were no signs of forced entry into her home, no stolen devices, and no witnesses. Yet, it was clear that a crime had occurred. When the matter was reported, investigators did not search for fingerprints or physical tools. Instead, they examined system logs, analysed deleted files, traced IP addresses, and reconstructed email trails. Through this digital examination, they identified how malware had entered the system, tracked the virtual path of the attacker, and gathered electronic evidence strong enough to stand in court.

This incident highlights the reality that modern crimes often exist entirely in digital form and cannot be solved using traditional investigative methods alone. The discipline that enables investigators to uncover, preserve, and analyse such electronic evidence is known as Cyber Forensics.

Cyber forensics refers to the scientific process of identifying, collecting, examining, and presenting digital evidence from computers, mobile devices, and networks in a legally admissible manner. In simple terms, cyber forensics is the branch of forensic science that deals with the investigation of cyber-crimes by analysing digital data to establish facts and support legal proceedings.

According to the National Institute of Standards and Technology (NIST, USA), cyber forensics is “the application of science to the identification, collection, examination, and analysis of data while preserving the integrity of the information and maintaining a strict chain of custody.” This definition emphasises the systematic and methodical approach required to handle electronic evidence without altering or damaging it. Similarly, the US Department of Justice (DOJ) defines cyber forensics as “the process of using scientific knowledge and methods to recover, analyse, and present digital evidence from computers and related digital storage devices for use in legal proceedings,” highlighting its role in the legal process.

INTERPOL further explains cyber forensics as involving “the identification, preservation, analysis, and documentation of digital evidence to support investigations of cyber-enabled and cyber-dependent crimes.” This definition underlines the international importance of cyber forensics in global cyber-crime investigations. Likewise, renowned cyber forensics expert Eoghan Casey defines it as “the process of preserving, identifying, extracting, and documenting computer evidence that can be used in a court of law,” focusing on evidence integrity and documentation.

In the Indian context, cyber forensics is commonly understood as “the branch of forensic science that deals with the systematic examination of electronic data to detect cyber-crimes and to present digital evidence in a legally acceptable form.” Combining the global and Indian perspectives, cyber forensics can be succinctly defined as the scientific and systematic process of identifying, preserving, analysing, and presenting digital evidence from computers, networks, and electronic devices in a manner that is legally admissible in a court of law. This discipline has become essential in combating modern cyber-crimes and ensuring justice in the digital age.

Case study 1. Silk Road (Dark Web Marketplace) Investigation

Background: Silk Road was a notorious online black market operating on the Dark Web where illegal drugs, fake IDs, and hacking tools were sold. Customers paid using Bitcoin to maintain anonymity.

Cyber Forensics Role: Investigators conducted extensive digital forensic analysis of web servers, Bitcoin transaction traces, and user metadata to link online activities back to real-world identities. By correlating Bitcoin wallets, login patterns, and network logs, law enforcement identified Ross Ulbricht, the founder of Silk Road. The arrest was followed by seizure of millions in Bitcoin.

Outcome: Ulbricht was convicted in 2015 and sentenced to life in prison. The case demonstrated how digital asset analysis and traceability of blockchain transactions can be vital in cyber investigations.

Significance: Silk Road is a landmark forensic case showing how experts can *penetrate anonymity (Dark Web + Bitcoin)* using methodical digital evidence collection, linking digital footprints to individuals.

Case study 2 Bangladesh Bank Cyber Heist (2016)

Background: Hackers exploited the Bangladesh Bank's SWIFT system, issuing fraudulent international payment instructions, attempting to steal nearly US $1 billion. Around US $101 million was successfully transferred before banking alerts stopped the rest.

Cyber Forensics Role: Forensic teams led by international specialists analysed the bank's network, discovered malware footprints and unauthorized access patterns, and reconstructed how the attackers moved through the banking system. They tracked timestamps, system logs, and SWIFT transaction anomalies to establish the timeline of the compromise.

Outcome: The malware presence was confirmed, remote origins traced, and some stolen funds recovered. The case became a global financial forensic reference point, illustrating the complexity of investigating high-value cyber financial crimes.

Case study 3 Sony Pictures Entertainment Hack (2014)

Background: North Korean-linked attackers breached Sony's corporate network. They leaked confidential emails, employee data, salaries, and unreleased films.

Cyber Forensics Role: Digital forensic experts analysed malware used in the intrusion, network logs, file timestamps, and communication channels to attribute the hack to a group known as Lazarus Group. Code re-use and unique malware signatures linked the attack to earlier cyber operations.

Outcome: This forensic evidence was used to attribute the attack to North Korea's cyber apparatus and inform corporate and government cybersecurity strategy.

Significance: Sony's case is a classic example of forensics-led attribution in state-linked cyber-attacks.

6.2.4.1 Significance of Cyber Forensics

In today's digital era, almost every crime leaves behind some form of electronic trace emails, social media messages, financial transactions, server logs, or encrypted files. Traditional investigation methods are insufficient to tackle crimes that occur entirely in cyberspace. Cyber forensics has emerged as a critical tool to investigate, analyse, and present digital evidence in a legally admissible manner. Its significance can be understood in the following ways:

1. **Investigation of Cyber Crimes :** Cyber forensics allows law enforcement and forensic experts to trace cyber criminals and reconstruct events of digital crimes. By analysing data from computers, networks, mobile devices, and cloud systems, investigators can detect hacking, phishing, ransomware attacks, online fraud, and identity theft. Without cyber forensics, many cyber crimes would remain unsolved because evidence exists only in digital form.
2. **Legal Admissibility of Digital Evidence :** Digital evidence is highly volatile and can be easily altered or destroyed. Cyber forensics ensures that evidence is collected, preserved, and documented following strict procedures (chain of custody), making it admissible in courts. This is essential for prosecution of cyber criminals and protection of victims' rights.
3. **Protection of Sensitive Data :** Cyber forensics helps identify data breaches, privacy violations, and unauthorised access. By analysing digital footprints and access logs, forensic experts can determine how breaches occurred, which data was compromised, and who is responsible. This is especially important for organisations handling sensitive personal, financial, or government data.
4. **Cybersecurity Enhancement :** Findings from cyber forensic investigations help organisations strengthen their cybersecurity measures. By identifying vulnerabilities and attack patterns, forensic analysis guides the implementation of firewalls, encryption, access controls, and monitoring systems. Essentially, cyber forensics is not only reactive (solving crimes) but also proactive (preventing future attacks).
5. **Detection of Complex and Cross-Border Crimes :** Many cyber crimes, like ransomware attacks or international banking frauds, involve perpetrators operating from multiple countries. Cyber forensics enables tracing of digital evidence across borders, supporting international cooperation and prosecution. Famous examples include the Bangladesh Bank Heist and Silk Road Dark Web investigation, where forensic analysis was pivotal in tracking global cyber criminals.
6. **Accountability in Corporate and Government Systems :** Cyber forensic investigations are essential in corporate governance, financial auditing, and e-governance. For example, in cases like the Sony Pictures Hack and the Equifax Data Breach, forensic evidence established responsibility, guided policy changes, and ensured accountability for mishandling of digital systems.
7. **Supporting Cyber Law and Judicial Systems :** Cyber forensics bridges the gap between technology and law. It ensures that digital evidence is scientifically validated and legally admissible, helping courts make informed decisions. Without cyber forensics, most digital crimes would lack reliable evidence to support convictions.

6.2.5 International Guidance to Cyber Forensics Laws

In today's digital world, cyber-crimes often span multiple countries, making it difficult for any one nation to investigate and prosecute offenders effectively. While India has developed its own cyber-crime and forensics framework under the IT Act, 2000, the challenges posed by cross-border crimes, cloud storage, encrypted communications, and emerging technologies demand guidance from international standards and best practices in cyber forensics.

International guidance to cyber forensic laws primarily comes from organisations and conventions that provide a framework for standardised evidence collection, preservation, analysis, and presentation in courts, enabling countries to cooperate efficiently in cyber investigations. The Budapest Convention on Cybercrime (2001), for instance, not only sets standards for criminalisation but also emphasises proper procedures for handling digital evidence, ensuring integrity, authenticity, and legal admissibility across borders. This provides a roadmap for nations like India to structure forensic investigations in line with global practices.

INTERPOL offers practical guidance for cyber forensics through its Global Cybercrime Programme, which trains investigators in techniques such as malware analysis, network forensics, log reconstruction, and digital traceability. It also issues protocols for handling evidence during international investigations, maintaining the chain of custody, and ensuring that evidence is admissible in multiple jurisdictions. This guidance allows countries to respond effectively to ransomware attacks, data breaches, and cyber espionage incidents.

The United Nations Office on Drugs and Crime (UNODC) provides policy guidance and capacity-building programmes for member states, focusing on cyber forensic standards, digital evidence handling, and cooperation between law enforcement agencies. These recommendations emphasise the need for centralised forensic labs, trained personnel, and standardised documentation procedures, ensuring scientific credibility of digital evidence in court proceedings.

Regional frameworks such as the European Union Cybercrime Directive and standards under GDPR offer additional guidance on preserving privacy while conducting forensic investigations. They outline procedures for collecting evidence without violating personal data rights, implementing secure storage, and documenting investigative actions. Countries can adapt these principles to ensure that cyber forensic investigations are both legally sound and privacy-compliant.

In addition to these frameworks, international professional bodies, forensic experts, and academic research provide guidelines on emerging practices, including cloud forensics, mobile device forensics, blockchain investigation, and artificial intelligence-based cyber investigation techniques. Adoption of such guidance ensures that forensic methods remain current with technological advancements and globally recognised standards.

International guidance to cyber forensic laws plays a pivotal role in creating uniform procedures, scientific reliability, and cross-border legal acceptability of digital evidence. By following standards and recommendations from bodies like INTERPOL, UNODC, and the Budapest Convention, countries including India can enhance the credibility, efficiency, and effectiveness of cyber forensic investigations. Such guidance ensures that cyber forensic practices are robust, internationally aligned, and capable of addressing the increasingly sophisticated nature of global cyber-crimes.

Recap

- ◊ Cyber-crime is any illegal activity carried out using computers, networks, or digital devices.
- ◊ Examples of Cyber Crimes in India include the Cosmos Bank Heist, Aadhaar Data Leak, Kerala Lottery Phishing Scam, Gulf Job Scam, and Social Media Impersonation.
- ◊ Indian Laws Dealing with Cyber Crimes are The IT Act, 2000 and sections 43, 66, 66C, and 66D govern cyber offences like hacking, identity theft, fraud, and unauthorised access.
- ◊ International Laws Dealing with Cyber Crimes includes the Budapest Convention, INTERPOL guidelines, UNODC recommendations, and EU Cybercrime Directive & GDPR.
- ◊ Cyber forensics is the process of collecting, analysing, and presenting digital evidence to investigate cyber-crimes and support legal proceedings.

Objective Questions

1. The Indian law governing cyber-crimes is called?
2. Section of the IT Act dealing with hacking is?
3. Identity theft in India is covered under Section?
4. Section dealing with cheating using digital communication is?
5. Section covering unauthorised access and computer damage is?
6. International treaty for cybercrime standardisation is?
7. UN body providing cybercrime guidance is?
8. Organisation providing global cybercrime investigation standards is?
9. EU regulation on data protection affecting cyber forensics is?
10. Process of collecting and analysing digital evidence is called?
11. Fake social media profile fraud is an example of?
12. Malware locking systems and demanding ransom is called?
13. Fraudulent emails asking for sensitive data are called?
14. The Indian cyber law enacted in the year?
15. Cyber-crime against computer networks and systems is called

Answers

1. IT Act
2. 66
3. 66C
4. 66D
5. 43
6. Budapest
7. UNODC
8. INTERPOL
9. GDPR
10. Cyber forensics
11. Impersonation
12. Ransomware
13. Phishing
14. 2000
15. Hacking

Self Assessment Questions

1. Describe the concept of cyber-crimes.
2. Explain different types of cyber-crimes.
3. Short note on any 2 examples of cyber-crimes.
4. Briefly explain the significance of Cyber forensic?
5. Discuss the national and international legal provisions to deal cyber-crime?

Assignments

1. Discuss the concept of cyber-crimes with real-life examples.
2. Discuss two famous cyber-crime cases in India.
3. Discuss international laws that guide cyber-crime investigations.

4. Explain the process of cyber forensics in investigating hacking cases.
5. Discuss a real-life case of social media fraud and how forensic methods solved it.

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FOURTH SEMESTER B.Com HONOURS EXAMINATION

MAJOR COURSE- SGB24CM204MC-

CORPORATE ACCOUNTING AND AUDITING (FYUGP - B.Com)

MODEL QUESTION PAPER- SET- A

2024-25 - Admission Onwards

Time: 3 Hours **Max Marks: 70**

SECTION A

Answer any eight questions in a word or sentence. Each question carries one mark

(8 × 1 = 8 Marks)

1. A company issues 150 equity shares of ₹10 each at par. How much is credited to Share Capital per share?
2. Define auditing
3. What is over-subscription of shares?
4. What is secured debenture?
5. what is QIP?
6. Short note on composite issue?
7. The amount received in advance from the shareholders is known as?
8. Define fraud?
9. Explain cyber forensics?
10. Short note on Hacking

SECTION B

Answer any six questions in two or three sentences each.

Each question carries two marks.

(6 × 2 =12 Marks)

11. List out any 4 qualities for an auditor?
12. Differnce between internal audit and internal control?

13. Pass the journal entry for the issue of debentures for cash at par.
14. List the precautions to be taken by an auditor while verifying and valuing assets and liabilities.
15. Short note on Budapest Convention on Cybercrime
16. List any 4 IPC provision for cyber-crimes ?
17. Briefly explain valuation of assets?
18. Short note on audit note book?

SECTION C

Answer any Six questions. Each question carries five marks.

(6 × 5 = 30 Marks)

19. Short note on objectives of auditing?
20. Describe the requirements of a voucher?
21. Discuss different types of shares
22. A company issued 25,000 equity shares of ₹10 each at par, payable ₹3 on application, ₹4 on allotment and ₹3 on first and final call. All the amounts were duly received. Pass the necessary journal entries.
23. AB Ltd borrowed rupee 30,00,000 from a bank at an annual interest rate of 12% and deposited 14% debentures of the face value of 45,00,000 as collateral security. Pass the journal entries regarding the issue of debentures as collateral security and also show the above items in the company's Balance sheet
24. Describe how internal check helps in preventing errors and fraud.
25. Short note on difference between debenture and share?
26. Short note on audit evidence?

SECTION D

Answer any two questions. Each question carries 10 marks.

(2 × 10 = 20 Marks)

27. Essay on legal provisions for cyber-crimes in India
28. A company invited applications from the public for the issue of 1,20,000 equity shares of ₹10 each at a premium of ₹ 2 per share, payable as follows: ₹4 on application, ₹4 (including premium) on allotment, ₹ 3 on first call and ₹1 on final call. Applications were received for 1,50,000 shares. Applications for 30,000 shares were rejected, and the remaining shares were allotted on a pro-rata basis. The company duly made both calls. All the amounts were received except the final call on 4,000 shares, which were forfeited after giving due notice. Subsequently, all the forfeited shares were reissued as fully paid at ₹9 per share. You are required to pass the necessary journal entries in the books of the company.

29. From the following figures relating to ABC Manufacturing Ltd. for the year ended 31 March 2024, prepare a Statement of Profit or Loss in accordance with Schedule III of the Companies Act, along with the necessary notes.

Particulars	₹
Sales	18,40,000
Sales Returns	65,000
Equity Share Capital	10,00,000
Opening Stock	55,000
Closing Stock	1,45,000
Raw Materials Consumed	9,20,000
Salaries	1,32,000
Outstanding Wages	8,500
Bonus to Employees	28,000
Provident Fund Contribution	1,05,000
Rent	52,400
Interest on Loan	22,500
Bad Debts	5,600
Depreciation on Machinery	25,000
Depreciation on Building	12,000
Machinery	7,50,000
Factory Building	2,10,000
Tax Expense for the Year	85,000

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FOURTH SEMESTER BACHELOR OF COMMERCE (B.Com) EXAMINATION

MAJOR COURSE- SGB24CM204MC-

CORPORATE ACCOUNTING AND AUDITING (FYUGP - B.Com)

MODEL QUESTION PAPER- SET- B

2024-25 - Admission Onwards

Time: 3 Hours **Max Marks: 70**

SECTION A

Answer any eight questions in a word or sentence. Each question carries one mark

(8 × 1 = 8 Marks)

1. What is audit engagement?
2. What is calls in arrears?
3. Explain SWEAT equity shares
4. Short note on Bonus issue?
5. What do you mean by voucher?
6. define cyber forensics
7. A company issues 200 equity shares of ₹100 each at par. How much is credited to Share Capital per share?
8. What is social audit?
9. State any 2 provisions related to cyber-crimes in IT act?
10. Short notes on forensic audit?

SECTION B

Answer any six questions in two or three sentences each.

Each question carries two marks.

(6 × 2 =12 Marks)

11. What is audit Programme?
12. State the journal entry for the issue of debentures at a discount.

13. State any 2 examples of corporate frauds in India?
14. List the any 4 international laws related to cybercrimes?
15. Differnce between valuation off assets and verification of assets?
16. State the objectives of auditing?
17. A company issued 1,000, 10% debentures of ₹100 each at par for cash. Pass the journal entry.
18. Short note on audit working papers?

SECTION C

Answer any Six questions. Each question carries five marks.

(6 × 5 = 30 Marks)

19. Differnce between audit and investigation?
20. Discuss the features of internal check?
21. Short note on minimum subscription?
22. Discuss the different types of debentures?
23. Lotus Ltd. issued 1, 50, 000 8% debentures of ₹150 each at a premium of 5% payable fully on application and redeemable at premium of ₹10. Give necessary journal entries at the time of issue of debentures.
24. Describe the difference between vouching and verification?
25. Explain the significance of forensic audit?
26. A company invited applications for 50,000 equity shares of ₹10 each, payable ₹3 on application and ₹7 on allotment. Applications were received for 70,000 shares. Applications for 10,000 shares were rejected and the balance shares were allotted on a pro-rata basis. Pass the necessary journal entries in the books of the company.**SECTION D**

Answer any two questions. Each question carries 10 marks.

(2 × 10 = 20 Marks)

27. Explain the different methods for issue of shares?
28. On 1st May 2024 Ivory Ltd issued 10, 000 12% debentures of ₹10 each at a discount of 5% redeemable on 30th June 2029. Issue was oversubscribed by 2, 000 debentures and the money was refunded. Interest is paid annually on 31st March. You are required to prepare:

    a. Journal entries at the time of issue of debentures.

    b. Discount on issue of debenture account

    c. Interest account and debenture holder account

29. From the following balances extracted from the books of PQR Ltd., prepare the Balance Sheet as at 31 March 2024 in accordance with Schedule III of the Companies Act.

Particulars	**₹**
Equity Share Capital	60,00,000
Securities Premium	1,50,000
Capital Reserve	90,000
Surplus in Profit and Loss Account	1,10,450
Long-term Loan from SBI	10,00,000
Provision for Employees' Benefits	7,20,000
Proposed Dividend	2,10,000
Short-term Borrowings	5,25,000
Trade Creditors	1,35,600
Bills Payable	92,400
Outstanding Expenses	68,000
Freehold Property	45,80,000
Furniture and Fixtures	6,70,000
Patents	9,50,000
Investment in Shares	4,20,000
Closing Stock	4,05,800
Trade Receivables	4,60,250
Cash and Bank Balances	3,75,900
Short-term Loans and Advances	3,00,000
Advance Income Tax	55,000

സർവ്വകലാശാലാഗീതം

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SAY NO TO DRUGS

LOVE YOURSELF AND ALWAYS BE HEALTHY

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