UNIT 10 COMPANY AUDIT-II

Structure

10.0 OBJECTIVES

After studying this unit, you should be able to:

- Explain the meaning of profit
- define divisible profits and dividends
- list different sources from which dividends can be declared
- describe the procedural/legal requirements regarding payments of dividends
- state auditor's duties regarding dividends
- describe the provisions of the act regarding depreciation and enumerate auditor's duties in this regard
- State auditor's duties in relation to reserves.

10.1 MEANING OF PROFIT

Different authorities have defined the term 'profit' in different ways. The economists ascertain profits by comparing the market values of its net assets at two accounting dates. They treat the increase or decrease in the net worth as the profit/loss for the intervening period. Accountants, on the other hand, view profit differently. According to them, profit can be computed as above provided business is going to be liquidated. In fact, business entity is regarded as going concern which is one of the fundamental accounting assumptions underlining the preparation of financial statements. Therefore, the accountant does not look at realisable value of assets as the basis for computing profit. Moreover, it is very difficult to measure objectively the market price of business assets especially the fixed assets. For an accountant, profit is the difference between the revenue and the expenses of an accounting period. In this context, the judgement in the case of Spanish Prospecting Co. Ltd. (1911) is noteworthy

"..... if the total assets of the business at two dates be compared, the increase which they show at the later date as compared with the earlier date (due allowances, of course, being made for any capital introduction into or taken out of the business in the meanwhile) represents, in strictness, the profits of the business during the period in question. The strict meaning of 'profit' is rarely observed in drawing up the accounts of firms and companies .... Certain assumptions have become so customary in drawing up

Balance Sheets and Profit and Loss Account that it may almost be said to require special circumstances to induce parties to depart therefrom. For instance, it is usual to exclude gains and losses arising from causes not directly connected with the business of the company ..... The value assigned to trade building and plant is usually fixed according to arbitrary rule, by which they are originally taken at their actual cost and are assumed to have depreciated by a certain percentage each year, though it cannot be pretended that any such calculation necessarily gives their true value either in use or exchange .... It is better to underrate than to overrate the profits since it is impossible for you to see all the risks to which a business may be exposed in future .... But though there is a wide field for variation of practice in these estimation of profits, this liberty ceases at once when the rights of third parties intervene .... In the absence of certain stipulation to the contrary, 'profits', in cases where the rights of third parties come in, mean actual profits and they must be calculated as clearly as possible, in accordance with the definition to which I have referred".

You may also note from the above that accounting policies play a very significant role in determination of true profits. You must have noticed that there are different accounting policies in vogue which may be followed by different enterprises. For instances, depreciation on fixed assets may be charged on straight line method or written-down value method. Depending upon the accounting policy followed by an entity, the figure of profit would also vary. Similarly, inventories are valued at cost or net realisable whichever is lower. The cost may be adopted by different accountants based on LIFO, FIFO, or specific identification method, etc. Each entity may adopt different estimate for writing off deferred revenue expenditure. Provision for bad and doubtful debts would depend upon the judgement of the management of the enterprise. Thus there can be no single magical figure of profit which would be arrived at under all circumstances.

In any case, it is necessary that profits are determined according to the generally accepted accounting principles as also having regard to the legal norms wherever applicable. Any overstatement of profit would result in payment of dividend out of capital consequently leading to reduction of capital and as such would be ultravires and void. The understatement of profit, on the other hand, affects the stakeholders interests and leads to creation of secret reserves which is prohibited under the Act.

10.2 DIVISIBLE PROFITS AND DIVIDENDS

You may note that the term "divisible profits" has not been defined anywhere in the Act. First of all it is necessary to ascertain correct profits by following generally accepted accounting principles. Then, it is not necessary that entire profits be distributed amongst owners of the enterprise and thus consumed. In fact a part of profits must be retained by the enterprise to finance its growth and diversification. In case of companies, the Act also imposes certain restrictions on the extent to which profits can be distributed amongst its members. Accordingly, the part of the profits of a company which can be legally distributed to its members is known as 'divisible profits', and that part of divisible profits which is actually distributed is known as 'dividend'. In practice, the generally accepted principles of accountancy, the relevant provisions of the Companies Act, 1956 and the various judicial pronouncements in different court cases are the guiding factors in determining divisible profits. Let us discuss these factors in the following paragraphs.

10.3 PROVISIONS OF THE COMPANIES ACT, 1956 FOR DIVIDENDS

Section 205 of the Act enumerates the sources from which dividends can be paid. It makes it compulsory for a company to provide for depreciation before declaring dividends. A company may also be asked to transfer some part of its profit to reserves if its intends to pay dividend exceeding certain limit. It also lays down the procedure for declaration and payment of dividends including the manner of dealing with any unpaid or unclaimed dividends. In this the context, it is equally important that leading judicial pronouncements on the issue are given due attention.

10.3.1 Sources of Dividends

According to Section 205(1) of the Act, dividend can be declared or paid by a company for any financial year only out of the following three sources

1 its profit for that year, arrived at after providing depreciation as per Section 205(2); or

2 its profits for any previous financial year or years, after providing depreciation as per the second provision to Section 205(1); or

3 money provided by the Central Government or a State Government for the payment of dividends in pursuance of a guarantee thereof.

Let us now discuss each source briefly alongwith conditions attached thereto:

Dividend out of Current Year Profits

A company has to comply with the following while paying dividends out of the profits of the current year:

a) **Provision for depreciation:** The profit for year would be arrived at only after providing depreciation both for the current year and for any past years.

b) **Set-off in case of past losses:** Where a company has incurred a loss in any previous year(s), it should be set off against its profits of the current year or of any previous year:

   i) the amount of loss for the previous year(s), or

   ii) the amount of depreciation provided for such previous year(s), which ever is lower.

   For example: a company incurred losses for the year 1994-95 and 1995-96 as per the details given below:

Year	Amount of Loss after charging depreciation	Provision for depreciation
	Rs.	Rs.
1994-95	25,000	40,000
1995-96	55,000	45,000

   During 1996-97, the company earned profit of Rs.1,25,000 and wished to declare dividends. In such a situation, the company shall have to set off Rs. 70,000 (Rs. 105,000 for the year 1994-95 and Rs. 45,000 for the year 1995-96) against the profits of current year. Therefore, the distributable amount in 1996-97 would be Rs. 55,000 (Rs. 1,25,000-Rs. 70,000).

c) **Transfer of Profits to Reserves:** A company must retain adequate funds to finance its growth. Therefore, the law requires that a company must transfer prescribed amount out of its current profits to reserves in case it intends to declare or pay dividend exceeding 10% on its paid up capital. However, there shall be no bar on a company if it voluntarily transfers a higher percentage of its profit to the reserves in accordance with such rules as may be made by the Central Government in this behalf. As at present, the relevant rules are as follows

Rate of dividend proposed (as percentage of paid-up capital)	Amount to be transferred to the reserves
i) Exceeding 10% but not exceeding 12.5%	Not less than 2.5% of current profits
ii) Exceeding 12.5% but not exceeding 15%	Not less than 5% of current profits
iii) Exceeding 15% but not exceeding 20%	Not less than 7.5% of current profits
iv) Exceeding 20%	Not less than 10% of current profits

Dividend out of Undistributed Profits of Past Years

A dividend may be declared by a company out of the undistributed profits of past years. In such a case also, the company has to provide for depreciation in case the same has not been provided earlier and set off losses of past years to the extent attributable to depreciation, in the same manner as in the case of a distribution out of current profits. Besides, the company has to also comply with the relevant rules viz., [Companies (Declaration of Dividend out of Reserves) Rules, 1975]. These rules allow a company to utilise its profits earned by it in past years and transferred to reserves, for paying dividends, subject to certain restrictions as below.

a) The rate of dividend should not exceed the average rate of dividend for the immediately preceding five years. This is subject to a further condition that the rate of dividend should not exceed ten per cent of the paid-up capital of the company.

b) The total amount to be drawn from the reserves should not exceed ten per cent of paid-up capital and free reserves of the company.

c) The amount drawn from reserves should be utilised, in the first instance, to set off the losses incurred in the current year, if any. Only the amount remaining after such set off can be utilised for paying dividend.

d) The balance of reserves after such withdrawal should not be less than fifteen per cent of the paid-up capital of the company.

For the purpose of the above requirements, the term 'reserves' does not include any reserves created on revaluation of fixed assets as well as any capital reserves. It is also important to note that the above conditions apply only where dividend is declared out of 'reserves'. Thus, a company can declare dividend out of the balance of profit for past years which has not been transferred to any reserve (i.e., balance shown in the balance sheet under the head 'Surplus') without complying with the above conditions.

Dividend out of Moneys Provided by the Central or a State Government.

The central government or a state government may, in some cases guarantee the payment of a certain rate of dividend to induce investors to make investment in companies where the returns are uncertain or where the gestation period is quite long. Where any money is provided by a government in pursuance of any such guarantee given by it, the money can be utilised for the payment of dividend.

10.3.2 Procedural/Legal Requirements

The procedure for declaration and payment of dividends is governed by Sections 205-207 of the Act and the provisions contained in the Articles of Association. Regulations 85-94 of Table A of Schedule I to the Act, deal with various aspects of dividends. It may be noted that a company can prescribe different rules. These rules can be summarised as follows:

1 **Authority for declaring dividend:** Regulation 85 of Table A provides that "the company in general meeting may declare dividends, but no dividend shall exceed the amount recommended by the Board".

2 **Dividend payable in cash only:** According to Section 205(3), dividends is only payable in cash. However, there is no prohibition as to capitalisation of profits or reserves by means of issue of bonus shares or paying up any amount, which is for the time being unpaid, in respect of any shares held by members of the company.

3 **Time Limit for payment of dividend:** The dividends declared by a company are required to be paid within forty-two days of such declaration. For this purpose, it is sufficient if the cheque or warrant in respect of the dividend payable is posted within the prescribed period of forty-two days.

4 **Unpaid dividend to be transferred to a special dividend account:** Under Section 205A(a), the company has been given 410 days' time from the date of declaration of dividend within which it must pay dividend or post dividend warrants to all shareholders entitled to the payment of dividend. However, if the

company does not comply with this, it is required under Section 205A(1) to transfer the entire amount of unpaid dividend to a special account in any schedule bank to be called Unpaid Dividend Account of Company Ltd. or (Private) Ltd. Such transfer should be effected within 7 days of the expiry of the 410-day period.

5 **Transfer of Unpaid or Unclaimed Dividend to Central Government:** Section 205A(5) provides that where (i) any unpaid or unclaimed dividend has been transferred by a company to a special bank account, and (ii) any amount transferred to such account is not paid or claimed within a period of three years from the date of the transfer, the amount remaining unpaid or unclaimed should be transferred to the general revenue account of the central government. Upon such transfer, any person who claims to be entitled to any amount of dividend so transferred, has to make an application to the central government for payment.

6 **Dividends not to be paid except to registered shareholders, or to their order, or to their bankers:** Under Section 206 of the Act, dividend in respect of any share shall be paid by a company-(i) to a registered holder of such share, or to his order, or to his banker; or (ii) in the case of a share warrant issued in respect of the share in pursuance of Section 114, to the bearer of such warrant or to his bankers.

7 **Right to dividend, rights and bonus shares to be held in abeyance, pending registration (Section 206A):** According to the new Section 206A inserted by the Companies (Amendment) Act, 1988, if any instrument of transfer has been delivered to any company for registration, and the transfer of such shares has not been registered by the company, then the company will be required to (i) to transfer the dividend in respect of such shares to the Unpaid Dividend Account (Section 205A), and the amount of the dividend will not be paid to the transferee as specified in the instrument of transfer unless the registered holder of such shares authorises the company in writing to do so, and (ii) keep in abeyance any offer of rights shares Section 81(1)(A) or any issue of fully-paid bonus shares Section 205(3) in respect of such shares.

8 **Right to dividend:** The right of claiming dividend arises only after the declaration of dividend in the company's general meeting. It is only after this that dividend becomes a debt. Dividend once declared in this way cannot be revoked, unless it is done so with the consent of the shareholders.

9 **No dividend for past years:** Dividend cannot be declared for past years in respect of which the accounts have already been closed in a previous annual general meeting. It is also beyond the powers of the company to declare a further dividend after declaration of dividend at the annual general meeting.

10 **Prohibition on declaration of dividend in case of failure to redeem preference shares:** Section 205(10B) prohibits a company, which fails to comply with the requirements of Section 80 A relating to redemption of any preference shares issued by it, from declaring any dividend on its equity shares so long as the failure continues.

10.3.3 Significant Legal Cases

Lee v. Neuchatel Asphalte Co. Ltd. (1889): The suit was filed by a shareholder seeking to restrain the directors of the company from distribution of dividend to the preference shareholders without providing for depreciation of the company's property. The Articles of the company specifically stated that the directors were not bound to set apart funds for renewal of replacement of any lease of mine, or for any other property or concession of the company. However, the directors were from time to time providing large amounts for writing off assets, though in the year to which the case related, they had not made any such provision. It was held in this case was "a company, empowered to do so by its Articles of Association may distribute dividends without making good the depreciation of wasting assets". From the auditor's point of view, an important point made in the judgement is as follows:

"If a company is formed to acquire or work any property of a wasting nature, e.g., a mine, quarry or patent, the capital expend in acquiring the property may be regarded as a sunk and gone, and any excess of money obtained by working the mine over the cost of working it, may be divided among the shareholders; and this is true, although some portion of the property itself is sold and, in one sense, the capital is thereby diminished".

Verner v. General and Commercial Investments Trust Ltd. (1894): The company had made substantial investment of its capital and proceeds of the issue of debentures in securities of other concerns. The investments fell steeply, without any foreseeable prospect of early recovery. In the year to which the case related, the company proposed to pay a dividend without providing for the loss in the value of its investments. The company was allowed to do so. It was decided that a company may pay dividends if it is solvent and is acting within its Articles even though the capital of the company is not intact.

Wilmer v. McNamara & Co. Ltd. (1895): The company proposed to pay dividend to its preference shareholders without providing for depreciation in respect of plant, goodwill, leases, etc., though in earlier years it had duly done so. An ordinary shareholder moved the Court to stop the company from giving effect to this. However, the court refused to intervene, applying the principle laid down in Lee v. Neuchatel Asphalte Co. it was decided that a company cannot be restrained declaring a dividend out of current profits for the reason that no provision has been made for depreciation of fixed assets.

Crabtree, Thomas v. Crabtree (1910): A trust was created for the benefit of the testator's wife. The trustees had, before ascertaining the profits of the business under trust, provided depreciation on the machinery employed therein. The beneficiary brought an action praying for disallowance of depreciation. The Court dismissed the case, holding that depreciation had been properly provided. The judgement held that normal charges in respect of depreciation of fixed assets ought properly to be made prior to the ascertainment of profits for distribution.

Ammonia Soda Co. v. Arthur Chamberlain (1918): The Profit and Loss Account of the company showed a loss owing mainly to the debits on account of depreciation, plant and machinery, mortgage and debenture interest, and directors' fees. Upon a boring made by the company to reach water, a hitherto unknown bed of rocksalt was discovered which, in the directors' opinion, was a reasonable enough ground to write up the value of company's property. The appreciation made in the value of land was used to write off losses disclosed by the Profit and Loss Account and in a subsequent year, a dividend was declared on preference shares out of the profits made. A suit was brought against the directors to make them liable for paying dividend out of capital. The Court rejected the plea holding that revaluation of properly was bonafide and no material information had been held back from the shareholders.

Held that, a company may write up its assets as a result of a bonafide revaluation, and may divide current profits without first writing off prior losses. There is no rule of law which forbids a company from setting off an appreciation in the value of its capital assets, as ascertained by a bonafide valuation against losses on revenue; and the dividend in this case was not in fact paid out of capital, but out of current profits.

Check Your Progress A

1 Define divisible profits.

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2 List sources of dividends.

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3 State whether the following statements are True or False.

i) Dividend for a year can be paid only out of profits of that year.

ii) In determining the amount of profits for a year out of which dividend can be paid, it is necessary to provide depreciation on fixed assets

iii) Before declaring dividend, it is necessary for a company to set off the entire amount of loss incurred by it in previous years.

iv) A company is required to transfer a certain percentage of its profits to reserves before declaring dividend, irrespective of the rate of dividend.

v) There is some restriction on the amount of dividends which can be declared out of reserves.

10.4 DISTRIBUTION OF CAPITAL PROFIT

Profits earned during normal course of the business can be distributed as dividends under Section 205 of the Act. Some profits do not arise in the normal course of business. Capital profits fall in that category. The capital profits arise on account of profits made on the sale of fixed assets/long term investments or on account of their revaluation. The question arises whether such profits can be distributed as dividends or not. The Act, however, has not specifically dealt with the issue. In this context, decisions in the following two leading cases may help in formulating some general conclusions.

Lubbock v. the British Bank of South America Ltd (1891): In January 1891, the British Bank of South America sold its branches in Brazil and repurchased them sometimes later at a profit of $2,05,000. The directors wanted to credit the Profit and Loss Account with this sum and to pay dividend to the shareholders. A shareholder brought about this friendly action to test and ensure the legality of this action of the directors. The action was brought just to elicit the opinion of the Court because the Articles of Association of the British Bank were silent on the point with regard to the calculation of divisible profits.

The court gave its opinion in favour of the directors and held that the dividends can be paid out of realised capital profits provided that:

1 the Articles of the company permit; and

2 a surplus is left after deducting the paid up capital and liabilities out of the sale proceeds, representing profit.

Foster v. The New Trinidad Lake Asphalt Co. Ltd. (1901): Company was formed to take over the assets of another business. The assets so taken over included promissory notes which, at that time, were estimated to be valueless. However, after a few years, it realised those promissory notes in full and credited the amount to Profit and Loss Account. The company proposed to use these profits for the payment of dividend. A shareholder brought about an action to restrain the company from using these profits as capital profits since they had arisen by realisation of those Promissory Notes which had been taken over by the company at the time of its formation and then considered valueless.

It was held that these capital profits cannot be distributed as dividend without having regard to the results shown by the accounts of the company as a whole. This would, therefore, require the revaluation of all the assets and liabilities of the company. Byrne J, in the course of his judgement restraining the distribution of dividends observed:

"If I rightly appreciate the true effect of the decisions, the question of what profits is available for dividend depends upon the result of the whole account — fairly taken for the year, capital as well as profit and loss, and although dividends may be paid out of earned profits, in proper cases. Although there has been a depreciation of capital, I do not think that a realised accretion to the estimated value of one item of the capital assets can be deemed to be profit divisible amongst the shareholders, without reference to the result of the whole account fairly taken".

On the basis of the above court decisions we come to the conclusion that the capital profits may be distributed as dividends provided the following conditions are satisfied:

1 The Articles of Association should permit distribution of capital profits as dividend.

2 Such profit which is sought to be distributed should have actually been realised. Unrealised capital profits, e.g., those arising on a revaluation of fixed assets, cannot be distributed as dividends. However, if the assets so revalued are subsequently sold, the amount realised over and above the original cost of such assets is a capital profit available for distribution as dividend, provided the other conditions are satisfied.

3 The capital profit should remain after a proper valuation has been fairly taken of the whole of the assets and liabilities. In other words, any fall or deficiency in the value of other assets or appreciation in the amount of liabilities should be deducted from the amount of capital profits to ascertain the amount which can properly be regarded as distributable as dividend.

It should be noted that capital receipts such as premium on shares and profits on reissue of forfeited shares cannot be distirbuted as dividends.

10.5 AUDITOR'S DUTY REGARDING DIVIDENDS

The auditor has to ensure that relevant provisions and procedure of the Companies Act, 1956 has been complied with regarding declaration and payment of dividends. The audit procedure to be involved the following:

1 Examine the Memorandum and Articles of Association of the company to ascertain the dividend rights of the various classes of shares.

2 Verify the rate of dividend and the authority for payment from the Shareholders' Minute Book.

3 Examine whether the procedural requirements relating to declaration of dividends had been complied with. The auditor examines the minutes of the board meeting at which the resolution recommending the declaration of dividends have been passed. He also examines the minutes of the general meeting at which the dividends have been declared.

4 Examine whether the dividends declared by the company had been paid within the prescribed time limit. For this purpose, the auditor examines the dividend registers showing the date(s) of despatch of cheques or dividend warrants.

5 Vouch the payment of dividends from the entries made in the Dividend Account, Profit and Loss Account, the Cash Book and the shareholders receipts. He will see that unclaimed dividend is shown in the Balance Sheet as a current liability and has been either deposited with a Scheduled Bank or the Government of India Account with the Reserve Bank, as the case may be.

6 Check the amount of gross dividends payable with reference to the paid-up share capital. Reconcile the net dividends payable with the gross dividends payable and the income-tax deducted at source. Check the gross and net dividends payable to individual members on a sampling basis.

7 Examine statement of unclaimed dividends with reference to the bank statement. Verify whether the company has complied with the requirements of the Act in this regard.

10.6 PROVISIONS RELATING TO DEPRECIATION

You know that it is essential to provide for depreciation to ascertain a true and fair view of the financial position of the enterprise. You have also learnt that in case of declaration of dividends, the Act requires that a company must provide for depreciation for the current year as well as for the past years for which no depreciation has been provided in the prescribed manner to compute the amount of divisible profits. It was laid in Lee v. Neuchatel Asphalt Co. Ltd, (1889) and Wilmer v. Mc.Namara and Co.

Ltd, (1895), that depreciation being an essential charge against profits must be provided for any before declaration of dividends.

10.6.1 Provisions of the Act

The relevant provisions of the Act in this regard which an auditor must observe are discussed in the following paragraphs.

According to Section 205(10), depreciation shall be provided either

a) to the extent specified in Section 350; or

b) in respect of each item of depreciable asset, for such an amount as is arrived at by dividing 95% of the original cost thereof to the company, by the specified period in respect of such asset; or

c) on any other basis approved by the Central Government which has the effect of writing off by way of depreciation, 95% of the original cost to the company of each such depreciable asset on the expiry of the specified period; or

d) as regards any other depreciable asset, for which no rate of depreciation has been laid down in Schedule XIV of the Act or by the Rules made thereunder, or such basis as may be approved by the Central Government by any general or particular order.

Provided that where depreciation is provided for in the manner laid down in clause (b) or clause (c), then, in the event of the depreciable asset being sold, discarded, demolished or destroyed, the written down value thereof at the end of the financial year in which the asset is sold, discarded, demolished or destroyed, shall be written off in accordance with the proviso to Section 350.

Under Section 205(1)(c), the Central, Government may, if it thinks necessary to do so in public interest, exempt any company from the requirement of providing depreciation before declaring or paying dividend for that year.

Thus, it is clear that a company may follow written down value method or straight line method, using the rates of depreciation specified in Schedule XIV to the Act. It may be noted that rates specified in Schedule XIV are the minimum rates and in case the management is of the opinion that the useful life of asset is likely to be shorter, it may provide depreciation at higher rates. In case of assets for which a rate has not been provided in Schedule XIV, depreciation should be provided on a basis approved by the Central Government by any general order or by a special order in a particular case. You may also note that as per Schedule XIV depreciation on fixed assets whose actual cost does not exceed Rs. 5000 should be provided at 100%.

Apart from the written down value methods or the straight line method, depreciation can also be provided on any other basis provided (a) the basis has the approval of the central government, and (b) by providing depreciation on such basis, 95 percent of the original cost of the asset should be written off on the expiry of the specified period.

10.6.2 Auditor's Duty

The auditor has to ensure that the depreciation provided as per the established accounting principles is adequate and reasonable, by whatever approved method or rate it may be calculated.. The other duties of an auditor in this regard are as under:

1 Examine that depreciation has been provided properly and is adequate since a lower charge of depreciation would distort true and fair view of financial statements and a higher charge would lead to creation of secret reserves

2 Ensure that depreciation is provided on a consistent basis. The effect of change in method should be quantified and disclosed.

3 See that when a change in method of depreciation is made, depreciation should be recalculated in accordance with the new method from the date of the asset coming into use. The deficiency or surplus of depreciation arising from the change in method should be taken to the profit and loss account.

4 Examine that the depreciation is provided on the revalued amount where an asset has been revalued. The effect of revaluation on the amount of depreciation should be disclosed separately in the year in which revaluation is carried out.

5 Ensure that net surplus or deficiency arising out of disposal/sale/discarded/ destruction etc. of asset is disclosed separately.

6 See that the following disclosures have been made in the financial statements:

a) Total depreciation for the period for each class of assets, as well as the related accumulated depreciation.

b) Accounting policy relating to depreciation, i.e.

i) the depreciation methods, followed and

ii) the depreciation rates used or the useful lives of the assets, if they are different from the rates prescribed by the statute governing the enterprise.

Check Your Progress B

1 State the conditions to be satisfied for distribution of capital profits as dividends.

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2 Distinguish between Capital profit and Capital receipt.

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3 State whether the following statements are True or false.

i) Profits on sale of fixed assets can never be distributed as dividends.

ii) A company can follow only the straight line method or the written down value method for providing depreciation for the purposes of provisions relating to dividends.

iii) If no rate of depreciation for a particular fixed asset is prescribed in Schedule XIV to the Companies Act, 1956, depreciation is not required to be provided in respect thereof.

iv) The rates of depreciation laid down in Schedule XIV to the Companies Act, 1956 are the minimum rates of depreciation. A company can provide depreciation at higher rates in appropriate cases.

v) The dividend declared by the shareholders of a company in general meeting can be higher or lower than the rate recommended by the board of directors.

vI) A company cannot declare dividend out of share premium account.

10.7 AUDIT OF RESERVES

You know that a company normally does not distribute the whole amount of profits earned in any accounting year and it is always considered prudent to retain some amount of profit in the form of reserves for meeting the growing capital needs of the company and its future exigencies. You learnt about the and various types of reserves created out of profits by a company in your first course on accounting viz., ECO-02 Accountancy-I. Here, we shall deal with the audit of reserves which acquires special significance since some reserves may not available for distribution of dividends.

The duties of an auditor regarding reserves are as under:

1 Check the opening balance of reserves with the previous years audited balance sheet.

2 Ascertain movement in reserves during the year and refer to Board's Resolution, etc.

3 Ensure that reserves do not contain an element of provisions.

4 Examine special reserves with reference to the relevant legal or contractual provisions i.e., whether the creation as well as the utilisation of such reserves is in accordance with the relevant legal or contractual provisions. For example, the Income-tax Act, earlier required the creation of an Investment Allowance Reserve under certain circumstances. The auditor has to ensure strict conformity to rules of the Act in this behalf.

5 Examine other reserves like general reserve or dividend equalisation reserve etc., with reference to the figures in the audited balance sheet for the previous year and the additions/withdrawals made during the year.

6 Examine that if there is a surplus in the profit and loss account after providing for proposed allocations to reserves and dividends, it is disclosed separately.

7 Ensure that no secret reserve has been created either by making excess provision, or under-valuation of assets, or mis-classification of expenditure, between capital and revenue etc.

Capital Reserves

i) Ensure that capital reserve does not include any amounts regarded as free for distribution as dividends. Accordingly, it is shown separately in the Balance Sheet and not mixed up with any other reserve or general reserve.

ii) See that it is created out of capital profits only. You may note that in the case of a company, capital profit, if any, on reissue of forfeited share is shown under capital reserves.

iii) Check that relevant provisions of the Act, Articles of Association etc. have been complied in case of its utilisation

Capital Redemption Reserve

i) Examine whether the capital redemption reserve has been created in accordance with the provisions of Section 80 of the Companies Act, 1956, and disclosed separately in the balance sheet. A sum equal to the nominal amount of the preference shares so redeemed has to be transferred from its distributable profits to a special reserve, called the capital redemption reserve account, except to the extent that a fresh issue of share capital has been made.

ii) Examine whether it has been utilised in accordance with Section 80 i.e. only for issuing fully paid-up bonus shares. Compliance with the requirements relating to bonus shares should also be examined.

Share Premium

i) Examine whether the premium is credited to the share premium account which is disclosed separately in the balance sheet.

ii) Check compliance with provision of Section 78 in respect of its utilization as under:

   a) for issuing fully paid-up bonus shares to the members of the company;

   b) for writing off the preliminary expenses of the company;

   c) for writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company; or

   d) for providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company.

iii) Ensure that details of utilisation of share premium account during the year, are disclosed in the balance sheet.

Revaluation Reserve

i) See that an increase in the book value of fixed assets consequent to a revaluation should be credited to revaluation reserve. It may be noted that revaluation reserve does not represent a realised gain and is, therefore, not available for distribution as dividend. Similarly, a company cannot issue bonus shares out of revaluation reserve.

ii) Ensure that accumulated losses and arrears of depreciation should not be adjusted against revaluation reserve.

iii) Ensure that depreciation on revalued assets is charged on the basis of the revalued figures. However, there is no legal bar if a company transfers an amount equal to the additional depreciation (i.e., depreciation attributable to increase in the book value of the fixed assets consequent to revaluation) from the revaluation reserve to the profit and loss account. However, in such a case, appropriate disclosures should be made in the financial statements.

Sinking Fund

i) Examine the terms and condition with reference to each sinking fund and see that the same are complied with. For example, in the case of creation of Debentures Redemption Fund under a trust deed, the auditor should see that all its requirements are being met.

ii) Ensure that sums are invested in earmarked securities.

iii) See that the sums set aside for the redemption of liabilities, or for acquisition of a new asset, are adequate and, for this purpose, auditor should go through the calculations of the amount to be invested and the rate of yield.

iv) See that any profit or loss on realisation or redemption of liability or acquisition of a new asset is carried to the Sinking Fund Account and not to the Profit and Loss Account.

10.8 LET US SUM UP

It is necessary that profits are determinated on the basis of generally accepted accounting principles as also the legal norms wherever applicable. The amount of profit that can be legally distributed as dividends is termed divisible profits Section 205 of the Companies Act, 1956 lays down necessary provision regarding payment of dividends.

Dividends can either be distributed out of current profits or out of past profits or in certain cases out of moneys provided by the Central or State Government. A company must provide for depreciation before declaring any dividend. As per the principles laid down in leading judgements capital profits can be distributed as dividends provided: (i) there exists an authority of the Articles of Association. (ii) there have actually been realised in cash, and (iii) revaluation of all assets and liabilities to write off all capital losses. The law is also requires that dividends be paid in cash within stipulated time limits.

Audit procedure to be followed by auditor to vouch dividends would include compliance with statutory requirements regarding computation of divisible profits, examination of General Meeting Minutes' Book, Register of Members, etc. He must ensure that depreciation has been provided strictly in conformity with the provision of the Act in terms of the method followed and the amount provided. He has also to ensure that necessary amount is duly transferred to reserves if dividends exceed the prescribed limit.

10.9 KEY WORDS

Capital Profit: Profit earned on the sale of fixed assets or long term investments.

Capital Redemption Reserve: A reserve created on redemption of the redeemable preference shares of a corporate enterprise out of its profits which would otherwise have been available for distribution as dividend.

Capital Reserve: A reserve of a corporate enterprise which is not available for distribution as dividend.

Cash Profit: The net profit as increased by non-cash costs, such as depreciation, amortisation, etc.

Dividend: A distribution to shareholders out of company's profits or reserves available for this purpose.

Divisible Profits: That part of profits which can be legally distributed as dividend.

Free Reserve: A reserve the utilisation of which is not restricted in any manner.

Sinking Fund: Fund created out of profits for redemption of debentures or replacement of a fixed asset.

Unclaimed Dividend: Dividend which has been declared by a corporate enterprise and a warrant or a cheque in respect whereof has been despatched but has not been encashed by the shareholder concerned.

10.10 ANSWER TO CHECK YOUR PROGRESS

A 3 (i) False (ii) True (iii) False (iv) False v) True

B 3 (i) False (ii) False (iii) False (iv) True (v) False (vi) True

10.11 TERMINAL QUESTIONS

1 What do you understand by 'Divisible Profits'? How are such profits determined?

2 What is the duty of a company auditor in relation to its divisible profits?

3 (a) Can a company declare dividend in a year without providing depreciation for the fixed assets and loss for the year? Discuss.

(b) Can a company pay dividend out of profits prior to incorporation? Explain.

(c) What are the circumstances under which dividend can be declared out of the profits previous years?

4 Can dividends be paid out of Capital Profits? If so, what are the legal limitations to such distribution?

5 When can the dividends be paid by a company out of the past accumulated profits or reserves?

6 A company may distribute dividend without making good the depreciation on its fixed assets. Comment giving legal decisions.

7 What are the provision with regard to unclaimed dividends? What are the duties of an auditor's in this regard?

8 State the legal requirements regarding provision for depreciation before declaring or paying dividend. State the duties of an auditor in relation thereto.

9 Enumerate the duties of an auditor with regard to audit of reserves.

> **Note :** These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the University. These are for your practice only.

SOME USEFUL BOOKS

Porwal & Kapoor, *Auditing, Theory and Practice*; Kitab Mahal, Allahabad, (Chapters 11-15)

Dinkar Pagare. *Principles and Practice of Auditing*. Sultan Chand & Sons, New Delhi, (Chapters 14, 15, 18-21)

Sharma Dr. T.R., *Auditing*. Sahitya Bhawan; Agra, (Chapters 9, 10 & 12)

Kamal Gupta and Ashok Arora. *Fundamentals of Auditing*. Tata McGraw-Hill Publishing Co. Ltd., New Delhi (Chapters 17 & 20).