PART-II

Statements on Reporting under section 227 (1A) of the Companies Act, 1956

Special Matters in Auditor's Report

Report under Section 227(1A) of the Companies Act

2.1 Section 227(1A) requires the auditor to make certain specific enquiries during the course of his audit. This requirement is without prejudice to his general rights, powers and duties regarding access to books, etc., and obtaining information and explanations. He is, however, not required to report on the matters specified in this sub-section, unless he has any special comments to make on any of the items referred to therein. If he is satisfied as a result of the enquiries, he has no further duty to report that he is so satisfied. It should however be noted that the auditor is required to make only enquiries on the matters specified in the sub-section and is not to investigate into the matters referred to therein.

2.2 Clauses (a) to (f) of Section 227(1A) of the Companies Act are discussed in the following paragraphs.

2.3 Clause (a) requires the auditor to inquire:

"Whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interests of the company or its members".

2.4 This clause applies to loans and advances made by the company during the financial year under audit, whether they are outstanding on the date of the Balance Sheet or not. The inquiry should be made in the light of conditions prevailing when the loan or advance was made.

2.5 Loans and advances have not been defined anywhere in the Act. However, having regard to the requirement of clause (d) of the sub-section, a distinction is obviously intended to be made between "loans and advances" and "deposits". A "deposit" may be defined as the placing of money or money's worth with a third party, either for safe keeping, or by way of security for the performance of the depositor's obligations, or for the purpose of earning interest; in the last case deposit being with a party who customarily accepts deposits. Any items required to be disclosed under the head "Loans and Advances" in Part I of Schedule VI to the Act which do not fall within the above definition of a "deposit" should be construed for the purpose of this clause as "loans and advances".

2.6 The clause applies to all loans and advances made "on the basis of security". "Security" for this purpose would include any movable or immovable property, whether belonging to the borrower or not, of which either physical possession or over which a legally effective charge is given to lender.

2.7 In order to ascertain that loans and advances are "properly secured", the auditor should make inquiries to ascertain that *prima facie*:

(a) the company holds a legally enforceable security, and

(b) the value of the security fully covers the amount of the loan or advance and is reasonably ascertained.

2.8 In order to comply with requirements of paragraph 2.7(a) above, it will be necessary for the auditor to make appropriate inquiries depending upon the type of security. A few instances are given below:

	Type of Security	*Documents etc. to be seen*
(a)	Shares and debentures	The scrips duly transferred in the name of the company.
(b)	Government securities, and other securities, documents of title which are transferable by endorsement and delivery, *e.g.* Bills of Lading, and Railway Receipts.	The scrips or other documents duly endorsed in favour of the lender.
(c)	Legal mortgage of immovable properties.	Duly registered mortgage deed.
(d)	Equitable mortgage of immovable properties.	Title deeds deposited. In both the above cases, reports on title by lawyers, showing whether the title is free from encumbrances and whether it is marketable, should be called for.
(e)	Life Insurance Policy	Assignment of policy in favour of the lender, duly registered with the insurer.
(f)	Pledge of goods	Appropriate record of goods held at the balance sheet date.
(g)	Hypothecation of goods	Deed of Hypothecation or other document creating the charge, together with a statement of stocks held at the balance sheet date.

2.9 The valuation of securities which are quoted on a stock exchange would not normally present any problems. For securities which are not so quoted, the auditor should call for the last accounts of the company whose shares or debentures are deposited as security and satisfy himself that *prima facie* the valuation placed on the security by the management is reasonable. In the case of immovable properties, the auditor should satisfy himself that the valuation placed on the property is *prima facie* reasonable. In the case of life insurance policies, the auditor should call for evidence of the surrender value of the policy. In the case of stocks and other goods held on pledge or hypothecation, the Auditor should ascertain that *prima facie* the valuation placed on the goods is in order.

2.10 The loan agreement or correspondence in regard to the terms of the loan or advance should be seen. Where the loan or advance is made to a company, any charge on the assets of such a company should have been registered under Section 125 of the Act in order to constitute an effective security.

2.11 Loans and advances on the basis of security would include loans or advances which are only partly secured from the commencement, or loans or advances which became partly secured subsequently owing to any reason, such as fall in the value of the security. In the case of partly secured loans or advances, it would be advisable to show them separately in the Balance Sheet as "partly secured", indicating the extent to which they are secured.

2.12 The "terms" on which the loan or advance is made would primarily include the security, the interest charged and the terms of repayment. It would be difficult to lay down any general principles regarding the rate of interest which may be charged on loans and advances. Various considerations, such as the position and standing of the borrower, type of security, purpose of the loan, prevailing market rate of interest, etc., would have to be taken into account. If the loan has been given for business considerations, *e.g.,* loans to staff for purchase of cars, houses, etc., loans to suppliers of raw materials or other goods, there may be justification for interest being charged at a rate lower than the market rate, or even, in appropriate circumstances, no interest being charged at all. However, when a loan is given only with a view to earning interest, the interest charged would be at the commercial rate.

2.13 Particular attention should be paid to loans or advances to concerns in which the directors of the company or their associates are interested.

2.14 The question whether the terms on which a loan or advance has been made are "prejudicial to the interests of the company or its members" is a difficult one. Obviously, the auditor is not to inquire as to how such transactions of the company affect the interests of individual members in their personal capacities. The reference to "members" should therefore be construed as a reference to the members of a company as a class, in their capacity as members. The members of the company would be primarily interested in a reasonable return on their investment and in the safety of their capital. The question whether a loan is prejudicial to the interests of the members should therefore be considered from this angle.

2.15 If loan or advance has been approved by the members of the company and/or the Government as required by Section 370 of the Act, this would be a *prima facie* evidence to show that it is not prejudicial to the interests of the company or its members.

2.16. It would appear that, in respect of a continuing loan or advance, the question whether the loan or advance is "properly secured" would have to be considered at the end of each accounting year. However, the question whether a loan is "prejudicial to the interests of the company or its members" would have to be considered only at the time when the loan is given, or renewed.

2.17 Under Clause (b) the auditor has to inquire:

"Whether transactions of the company which are represented merely by book entries are not prejudicial to the interests of the company."

2.18.The transactions of a company are ordinarily matters of fact. The purpose of book entries is to correctly record transactions which have, in fact, taken place. If a book entry is passed which is not in accordance with the facts of the transaction, or is contrary thereto, this should be set right or reported upon by the auditor. Again, if book entries are passed purporting to record "transactions" which have, in fact, not taken place, similar considerations would apply. The clause is therefore intended to cover transactions of the company for which the only evidence, or the principal

evidence, is the entry regarding the transactions in the books of account. In such cases, the auditor should inquire whether such transactions have in fact taken place and, if so, whether they are prejudicial to the interests of the company.

2.19 Under Clause (c) the auditor has to inquire:

"*Where the company is not an investment company within the meaning of section 372 or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company".*

2.20 This clause requires the auditor to inquire in all cases where shares, debentures or other securities have been sold at a price less than their cost. If, as a result of his inquiries, the auditor is satisfied that the sale is *bona fide* and the price realised is reasonable, having regard to the circumstances of the cases, he has no further duty to report on the matter.

2.21 The clause applies to companies other than an "investment company" within the meaning of Section 372 or a banking company. The "investment company" referred to in this clause is a company whose principal business is the *acquisition* of shares, stocks, debentures or other securities (vide the proviso to Section 372[10]). It should be noted that clause (c) *applies* to a company whose principal business is dealing in shares, stocks, debentures or other securities.

2.22 Where the investments consist of securities of the same class purchased at various times, and at various prices, the question arises as to the manner of ascertainment of the price at which they were purchased. Such price should be determined in accordance with accepted accounting practice consistently followed by the company.

2.23 Where the cost of shares or debentures or other securities sold is not ascertainable, the book value thereof at the date of sale may be treated as the cost for the purposes of this clause.

2.24 The question of treatment of bonus shares would also arise. When bonus shares are received, the number of shares in the portfolio would be increased by the bonus shares while the cost of the total portfolio would remain the same as before. The result would be that the average cost per unit of the total holding would come down proportionately. The usual accounting practice for apportioning the cost of a part of the total holding on the sale thereof is to take it at its average cost.

2.25 Under Clause (d) the auditor has to inquire:

"Whether loans and advances made by the company have been shown as deposits".

2.26 A reference is invited to the definition of a "deposit" in contradistinction to that of a loan or advance given in the comments on clause (a) above. It should be noted that the inquiry to be made is whether loans and advances have been shown as deposits, and not *vice versa*.

2.27 Clause (e) requires the auditor to inquire:

"*Whether personal expenses have been charged to revenue account".*

2.28 The practice of meeting certain types of personal expenses of employees is normal and is recognised both by the Income-tax Authorities and the Company Law Board. Illustrative of such

expenses are the provision of rent-free quarters, conveyance for personal use, medical expenses, expenses on leave travel, maternity benefits, canteen facilities, etc. The charging to revenue of such personal expenses, either on the basis of the company's contractual obligations, or in accordance with accepted business practice, is perfectly normal and legitimate and does not call for any special comment by the auditor. Where, however, personal expenses not covered by contractual obligations or by accepted business practice are incurred by the company and charged to revenue account, it would be the duty of the auditor to report thereon.

2.29 Clause (f) requires the auditor to inquire:

"Where it is stated in the books and papers of the company that any shares have been allotted for cash, whether cash has actually been so received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading."

2.30 It should be noted that the reference is to "books and papers". "Papers" would presumably refer to the Return of Allotment filed by the company under Section 75 of the Act. The law on the subject has hitherto been that, where the consideration for the issue of shares is an adjustment against a *bona fide* debt payable in money on demand by the company, the shares are deemed to have been subscribed in cash (vide the decision in Spargo's Case – 1873, 8, Ch. A. 407). According to the legal opinion obtained by the Institute, the expression "shares allotted for cash" may also include shares allotted against a debt. Therefore, in cases which are covered by the decision in Spargo's case, no comment is required by the auditor, even though the company may have in the Return of Allotment under Section 75, shown such shares as allotted against adjustment of a debt.