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GUIDANCE NOTE ON AUDIT OF MISCELLANEOUS EXPENDITURE SHOWN IN BALANCE SHEET*

Contents

Paragraph(s)

* Published in October, 1995 issue of 'The Chartered Accountant'. The Guidance Note has since been revised in 2003 and the same is published at Sl.No. 41 in this Volume. This Guidance Noe will be withdrawn in due course.

The following is the text of the Guidance Note on *Audit of Miscellaneous Expenditure Shown* in Balance Sheet issued by the Auditing Practices Committee (APC)** of the Council of the Institute of Chartered Accountants of India. This Guidance Note should be read in conjunction with the Statements on Standard Auditing Practices (SAPs)++ issued by the Institute.

1. Para 2.1 of the *Preface to the Statements on Standard Auditing Practices* issued by the Institute of Chartered Accountants of India states that the "main function of the APC is to review the existing auditing practices in India and to develop Statements on Standard Auditing Practices (SAPs) so that these may be issued by the Council of the Institute." Para 2.4 of the Preface states that the "APC will issue Guidance Notes on the issues arising from the SAPs wherever necessary."

2. The Auditing Practices Committee has also taken up the task of reviewing the Statements on auditing matters issued prior to the formation of the Committee. It is intended to issue, in due course of time, AASs or Guidance Notes, as appropriate, on the matters covered by such Statements which would then stand withdrawn. With the issuance of this Guidance Note on Audit of Miscellaneous Expenditure Shown in Balance Sheet, Chapter 10 of the *Statements on Auditing Practices,* titled "Miscellaneous Expenditure", shall stand withdrawn. In due course of time, the entire *Statements on Auditing Practices* shall be withdrawn.

Introduction

3. 'Miscellaneous expenditure' shown in the balance sheet of companies (or shown under this or some other appropriate heading in the balance sheet of other enterprises) embraces within its fold a variety of items of expenditure which are not entirely charged to income in the year in which they are incurred, but are carried forward in the balance sheet to be written-off in subsequent periods. Unless some benefit from the expenditure can reasonably be expected to be received in future and unless the amount of such benefit is reasonably determinable, there is no justification for carrying forward the expenditure for being written-off in subsequent periods. Also, the amount of expenditure to be carried forward should not exceed the expected future revenue/other benefits related to the expenditure.

** Now known as the Auditing and Assurance Standards Board (AASB).

++ Now known as the Auditing and Assurance Standards (AASs).

4. 'Miscellaneous expenditure' normally comprises the following items, besides others:

(a) Preliminary expenses.

(b) Expenses including commission or brokerage on underwriting or subscription of shares or debentures.

(c) Discount allowed on the issue of shares or debentures.

(d) Development expenditure.

5. 'Miscellaneous expenditure' may constitute a significant item of balance sheet in certain situations such as after a large public issue of shares, debentures or other securities, or after incurring a heavy development expenditure. The audit of miscellaneous expenditure assumes considerable importance in such situations.

6. The following features of miscellaneous expenditure have an impact on the related audit procedures.

(a) The items of expenditure included under this heading do not represent any tangible asset.

(b) The expenditure on these items is usually of a non-recurring nature.

(c) There is a justification for deferring the expenditure on the basis that the benefits from the expenditure can reasonably be expected as flowing into the future, the amount of such benefits is reasonably determinable, and the amount of deferred expenditure does not exceed the expected future benefits related thereto.

(d) Unless some fresh expenditure is incurred, the balance in these items reduces each year by the amount written-off in that year.

7. The auditor's primary objective in audit of items shown in the balance sheet under the head 'miscellaneous expenditure' is to satisfy himself that:

(a) it is proper to defer the expenditure;

(b) the period of amortisation of the expenditure is reasonable;

(c) the expenditure shown to have been incurred during the year actually occurred during the year and there is proper authority for the expenditure and for its deferral;

(d) the criteria which previously justified the deferral of the expenditure continue to be met and the expected future revenue/other benefits related to the expenditure continue to exceed the amount of unamortised expenditure.

Internal Control Evaluation

8. The auditor should study and evaluate the system of internal control relating to the various items of miscellaneous expenditure to determine the nature, timing and extent of his other audit procedures. He should particularly review the following aspects.

(a) There should be a system of control over expenditure incurred on these items. An effective method of exercising such control is budgeting which, apart from ensuring proper authorisation of the expenditure incurred, also shows in general how effectively such expenditure is being controlled. This is accomplished through periodical comparisons of actuals with budgeted figures.

(b) Accountability should be established over each item of such expenditure. This can be achieved, *inter alia*, by up-to-date maintenance of proper records.

(c) The system should ensure that reliable information (including reports of experts) is available for assessment of the results achieved against the objectives and estimates of the expenditure determined originally.

Verification

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

10. While verifying an item of miscellaneous expenditure in the year in which the relevant expenditure is incurred, the auditor should satisfy himself regarding the amount of such expenditure and its deferral as also regarding the reasonableness of the period of amortisation of the expenditure. Till the amount is fully amortised, the auditor should examine every year that a proper amount is amortised during the year by way of a charge to income for the year(and not as its appropriation). The auditor should also examine every year that the criteria which previously justified the deferral of the expenditure continue to be met. If those criteria no longer apply, the auditor should examine whether the unamortised balance has been charged as expense

immediately. Where the auditor finds that the criteria for deferral continue to be met but the amount of unamortised balance of the expenditure exceeds the expected future revenues/other benefits related thereto, the auditor· should examine whether such excess has been charged as an expense immediately.

11. The special considerations in audit of various items of miscellaneous expenditure are discussed in paragraphs 12-21 below:

Preliminary Expenses

12. Preliminary expenses are the expenses relating to the formation of an enterprise. For example, in the case of a company, preliminary expenses would normally include the following.

(a) Legal costs in drafting the memorandum and articles of association.

(b) Fees for registration of the company.

(c) Cost of printing of the memorandum and articles of association and the statutory books of the company.

(d) Any other expenses incurred to bring into existence the corporate structure of the company.

13. The auditor should verify these expenses with reference to supporting documents such as invoices and contracts relating to these expenses. In the case of a company, the auditor should also examine that the reimbursement of such expenses to promoters is in accordance with the disclosures made in the prospectus. Compliance with legal provisions regarding reimbursement of the promoters' expenses should be specifically examined.

Expenses including Commission and Brokerage on Underwriting or Subscription of Shares and Debentures

14. The auditor should examine whether the payment of brokerage, commission, etc., is authorized by articles of association or other rules/regulations and is in accordance with the provisions of the relevant statute.

15. The auditor should also examine whether the rates of commission paid or payable to brokers and underwriters are in accordance with the disclosures made in the prospectus. The auditor should verify the commission with

reference to the agreements with brokers and underwriters.

16. The auditor should examine the certificate issued by the merchant bankers with regard to commission payable to underwriters, and ensure that the payment made to underwriters is in accordance with such certificate.

17. Other expenses on issue of shares or debentures, such as fees of the managers to the issue, fees of the registrars to the issue including mailing and handling charges, fees of the advisors to the issue, advertisement expenses, expenses on printing and supply of prospectus and application forms, expenses on printing of share/debenture certificates, etc., should be verified with reference to supporting documents such as invoices, agreements, etc. The auditor should also examine whether the limits on such expenses as laid down in the applicable statute have been complied with.

Discount Allowed on Issue of Shares or Debentures

18. The auditor should examine whether the amount of discount allowed on issue of shares is in accordance with the provisions of the relevant statute. He should also examine whether the amount of discount allowed on issue of shares or debentures conforms to the disclosures made in prospectus, returns and other documents.

Development Expenditure

19. The auditor should verify the development expenditure with reference to supporting documents such as purchase invoices, agreements with third parties, etc. The auditor should examine that the deferral of the expenditure on research and development is in accordance with the recognised accounting policies and practices (see Accounting Standard 8, *Accounting* for *Research and Development,* issued by the Institute of Chartered Accountants of India). In this regard, the auditor should seek appropriate representations from the management. Where the research programme is approved by specific authorities, the auditor should review their report. The auditor should also examine that the deferred expenditure on research and development is allocated to future accounting periods on a systematic basis by reference either to the sale or use of the related product or process or to the time period over which the related product or process is expected to be sold or used. The auditor should also satisfy himself that the criteria justifying the deferral of the expenditure on research and development continue to be

met and that the unamortised balance of the deferred expenditure on research and development does not exceed the expected future revenue/other benefits related thereto.

Other items

20. The auditor should examine whether the deferral and the amortisation of expenditure incurred during the construction period are in accordance with recognised accounting policies and practices (see, for example, *Guidance Note on Treatment of Expenditure During Construction Period,* issued by the Institute of Chartered Accountants of India).

21. Where the entity incurs heavy expenditure of a revenue nature during the year, the benefits of which are likely to extend beyond that year, the expenditure may sometimes be deferred and written-off over the number of years for which the benefits are expected to be derived by the entity. Some instances of such expenditure are removal of business from one location to another, massive advertisement in one year to introduce a product or develop a market. In such cases, the auditor should examine whether the deferral of the expenditure meets the relevant criteria and whether the amount of periodic write-off of the expenditure is appropriate.

Disclosure

22. The auditor should examine whether the financial statements disclose the nature and amount of miscellaneous expenditure. The financial statements should also disclose the amortised portion of deferred expenditure charged to income for the year. The accounting policy followed by the entity for deferral and the period of write-off of such expenditure, if significant, should also be disclosed in accordance with Accounting Standard (AS) 1, *Disclosure of Accounting Policies.*