Paper 12- Company Accounts & Audit

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Full Marks: 100 **Time allowed: 3 hours**

Section – A

I. Answer all the following questions.

1. Answer the following questions: [5x2=10]

(i) A Company has its Share Capital divided into Equity Shares of ₹10 each. On 01.10.2013, it granted 20,000 Employees' Stock Option at ₹ 50 per Share, when Market Price was ₹ 120 per share. The Options were to be exercised between 10.12.2013 and 31.03.2014. Employees exercised their options for 16,000 Shares only, and the remaining options lapsed. The Company closes its books on 31st March every year. Show Journal Entry (with narration) as would appear in the Company's books upto 31.03.2014.

Answer:

Journal Entry for ESOP

Particulars		Dr. (₹)	Cr.(₹)
Bank A/c (16,000 Shares × ₹ 50)	Dr.	8,00,000	
Employees' Compensation Expense A/c	Dr.	11,20,000	
(16,000 Shares × ₹ (120-50) i.e. 70)			
To Equity Share Capital A/c (16,000 Shares × ₹ 10)			1,60,000
To Securities Premium A/c [16,000 Shares × ₹ (120 – 10)]			17,60,000
(Being 16,000 Shares allotted to Employees under ESOP at a Premium of ₹ 110 per share)			

(ii) Differentiate between Reporting Currency and Foreign Currency .

Answer:

Difference between Reporting Currency and Foreign Currency:

Particulars	Reporting Currency	Foreign Currency
Meaning	It is the currency used in presenting the Financial Statements.	It is a currency other than the Reporting Currency of an enterprise.
Example	Indian Rupees is the Reporting Currency for an Indian Company.	Any currency other than Indian Rupees is a Foreign Currency for an Indian Company.

(iii) Prafullya Ltd. issued 80,000 shares. Issued is underwritten by P,Q, and R in the ration of 5:3:2 respectively. Unmarked applications totaled 4,000 whereas Marked Applications are : P – 32,000 shares, Q – 11,400 shares and R – 16,600 shares.

Calculate the Gross Liability of each of the Underwriters.

Answer:

Statement of Underwriters' Gross Liability

Particulars	**P**	**Q**	**R**	**Total**
Gross Liability (5:3:2)	40,000	24,000	16,000	80,000

(iv) State the disclosure requirement under schedule III of the following items:
- **Debit balance of Profit & Loss account**
- **Unsecured Bank loan**

Answer:

- **Debit balance of Profit & Loss account -** To be shown as a negative figure under "Surplus".
- **Unsecured Bank loan -** If it is repayable after 12 months – to be sub-classified under "Long-term Borrowing" to be presented as a separate line item. Also state the terms of repayment, and If it is repayable within twelve months – to be sub – classified under "other current liabilities. To be shown as a separate line item.

(v) Foreign currency creditors at the end of the financial year are USD 10 Lakhs. Purchase were recorded at the exchange rate USD 1= ₹52. On the balance sheet date, the exchange rate is USD 1 = ₹54 which is not expected to be payable on the payment date. It has been estimated that around the payment time, the exchange rate will possibly be in the range of USD 1 - ₹55.00 to ₹56.50. At what value should the creditors be recorded in the balance sheet? What is the treatment of foreign exchange loss?

Answer:

Creditors should be recorded at the expected payable value, i.e. Average Expected Rate = (₹55.00 + ₹56.50) ÷ 2 = ₹55.75 per USD. The amount of creditors recognized in the Balance Sheet shall be ₹55.75 x 10 Lakhs USD = ₹557.50 Lakhs.

<u>Treatment of foreign exchange loss –</u>

The Exchange Loss of (₹55.75 – ₹52) x 10 Lakhs USD = ₹37.50 Lakhs should be recognized as loss in the Profit & Loss account.

2. Matching the following: **[5x1=5]**

	Column 'A'		**Column 'B'**
1.	**Balance of Forfeited Shares A/c**	**A.**	**Dividend Unpaid**
2.	**Contingent Liability**	**B.**	**Accounting for Government Grants**
3.	**AS – 12**	**C.**	**Segment Reporting**
4.	**Current liability**	**D.**	**Notes to Accounts**
5.	**AS – 17**	**E.**	**Capital Reserve**

Answer:

	Column 'A'		**Column 'B'**
1.	Balance of Forfeited Shares A/c	E.	Capital Reserve
2.	Contingent Liability	D.	Notes to Accounts
3.	AS – 12	B.	Accounting for Government Grants
4.	Current liability	A.	Dividend Unpaid
5.	AS – 17	C.	Segment Reporting

3. Answer the following questions: **[5x2=10]**

(i) What is the purpose of audit?

Answer:

The auditor's opinion on the financial statements deals with whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. The auditor's opinion therefore does not assure, for example, the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity. The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.

(ii) Re-appointment of an auditor – Comment.

Answer:

- A retiring auditor may be re-appointed at an annual general meeting, if—
  (a) he is not disqualified for re-appointment;
  (b) he has not given the company a notice in writing of his unwillingness to be re-appointed; and
  (c) a special resolution has not been passed at that meeting appointing some other auditor or providing expressly that he shall not be re-appointed;
- Where at any annual general meeting, no auditor is appointed or re-appointed, the existing auditor shall continue to be the auditor of the company;
- Where provision of section 177 is applied, all appointments, including the filling of a casual vacancy of an auditor shall be made after taking into account the recommendations of such committee.

(iii) List the advantages of Balance Sheet Audit.

Answer:

Advantages of Balance Sheet Audit

(1) Balance sheet audit commences after the completion of books of accounts. The management prepares the Balance Sheet, therefore changes in the accounts is not possible once the verification process is started.

(2) No interruption from the accounts department. Checking can be done smoothly without any breaks in between.

(3) No loose links because audit is conducted in a continuous flow, which reduces the chances of missing the verification of any aspect.

(4) Sample tests reduce the time involved for routine checking. The saving on account of time results in cost effectiveness.

(iv) List the objectives and functions of Auditing and Assurance Standard Board.

Answer:

Following are the objectives of Audit and Assurance Standard Board:

(i) To review the existing and emerging auditing practices worldwide.

(ii) To formulate Engagement Standards, Standards on Quality Control and Statement on Auditing.
(iii) To review and revise the existing Standards and Statements on Auditing.
(iv) To develop Guidance Notes on issues arising out of any Standard, auditing issues pertaining to any specific industry and revise.
(v) To review and revise the existing Guidance Notes.
(vi) To formulate General Clarifications, where necessary, on issues arising from Standards.
(vii) To formulate and issue Technical Guides, Practice Manuals, Studies and other papers.

(v) What is vouching?

Answer:

The act of examining all documentary evidence is referred to as vouching. Its basic objective is to establish the authenticity of the transactions recorded in the primary books of accounts. Vouching is said to be "the essence of auditing (or) may be termed as the backbone of auditing; It serves as evidence, assurance, preliminary for verification, establisher's authenticity.

Section – B

II. Answer any three questions out of the following: [3×15=45]

4. (a) Alpha Ltd issued a prospectus inviting applications for 2,000 shares of ₹ 10 each at a premium of ₹ 2 per share, payable as follows:

On Application ₹ 2, On Allotment ₹ 5 (including premium)
On First Call ₹ 3, On Second & Final Call ₹ 2

Applications were received for 3,000 shares and pro rata allotment was made on the applications for 2,400 shares. It was decided to utilise excess application money towards the amount due on allotment.
Mohit, to whom 40 shares allotted, failed to pay the allotment money and on his subsequent failure to pay the first call, his shares were forfeited.
Jagat, the holder of 60 shares failed to pay the two calls and on his such failure, his shares were forfeited. Of the shares forfeited, 80 shares were sold to Rishav credited as fully paid for ₹ 9 per share, the whole of Mohit's shares being included. [12]

Required: Give Journal Entries to record the above transactions (including cash transactions)

Answer:

Journals

Particulars	L.F.	Dr. Amount ₹	Cr. Amount ₹
Bank A/c Dr. To Share Application A/c [Being the application money received on 3,000 shares)		6,000	 6,000

Share Application A/c Dr. To Share Capital A/c To Bank A/c To Share Allotment A/c (2,000@ ₹0.40) [Being the transfer and refund of application money received on 3,000 shares]		6,000	 4,000 1,200 800
Share Allotment A/c Dr. To Share Capital A/c To Securities Premium A/c [Being the allotment money due]		10,000	 6,000 4,000
Bank A/c Dr. Calls in Arrear A/c Dr. To Share Allotment A/c [Being the remaining allotment money received on 1,960 shares]**		9,016 184	 9,200
Share First Call A/c Dr. To Share Capital A/c [Being the first call money due]		6,000	 6,000
Bank A/c Dr. Calls in Arrear A/c Dr. To Share First Call A/c [Being the first call money received on 1,900 shares @ ₹ 3 per share]**		5,700 300	 6,000
Share Capital A/c (40 × ₹8) Dr. Securities Premium A/c Dr. To Calls in Arrear A/c (184 +120) To Forfeited Share A/c [Being 40 shares forfeited for non-payment of full allotment money and the first call money]		320 80	 304 96
Share Second & Final Call A/c Dr. To Share Capital A/c [Being the second and final call due on 1,960 share]		3,920	 3,920
Bank A/c Dr. Calls in Arrear A/c Dr. To Share Second and Final Call A/c [Being the second and final call received on 1,900 shares]		3,800 120	 3,920
Share Capital A/c Dr. To Calls in Arrear A/c To Forfeited Shares A/c [Being 60 shares forfeited for non-payment on the first call and final call]		600	 300 300
Bank A/c Dr. Forfeited Shares A/c Dr. To Share Capital A/c [Being the reissued of 80 shares @ ₹ 9 as fully paid up]		720 80	 800
Forfeited Shares A/c Dr. To Capital Reserve A/c [Being the transfer of profit on re-issue] [On 40 @ ₹(2.40 - 1.00) = 56 On 40 @ ₹(5.00 – 1.00) = 160 216]		216	 216

Working Notes:

(i) Calculation of the amount due but not paid on allotment in Case of Mohit

	₹
Total No. of shares applied by Mohit (40 × 2,400/2,000) 48	
Total money sent on application by Mohit (48 × ₹ 2)	96
Excess application money [₹ 96 – (40 × ₹ 2)]	16
Total amount due on allotment (40 × ₹ 5)	200
Amount due but not paid on allotment (₹ 200 – ₹ 16)	184

(ii) Calculation of allotment money received later on

Total allotment money due (2,000 × ₹ 5)		10,000
Less: (a) Already received	₹ 800	
(b) Not received (as per note 1)	₹ 184	984
		9,016

(iii) Since the question is silent as to the utilization of ₹ 16 (received from Mohit) between share capital and securities premium, it has been assumed that the entire excess of ₹ 16 is exclusively for share capital and hence credited to Forfeited Shares Account in full.

**Alternative Calculation —

Ratio of allotment = 2,000:2,400 = 5:6
Advance per share = (6×2 – 5× 2)/5 = ₹0.40
∴due on allotment = ₹5-0.40 = ₹4.60

Unpaid money or calls in arrear —	allot	Call-1	Call-2
Mohit (40) @ 4.60	184	120	-
Jagat (60)	-	180	120
	184	300	120

(b) Brief the disclosure requirements as per AS – 11 . [3]

Answer:

Disclosure under AS -11:
An enterprise should disclose:

(a) The amount of exchange difference included in the net profit or loss for the period.
(b) The amount of exchange difference adjusted in the carrying amount of fixed assets during the accounting period.
(c) The amount of exchange difference in respect of forward contracts to be recognized in the profit/ loss for one or more subsequent accounting period.
(d) Foreign currency risk management policy.

5. (a) Kachari Limited granted 25,000 employees stock options (face value ₹10) on 1st April, 2012 at ₹100, when the market price was ₹425. The options were to be exercised between 16th October, 2012 and 15th March, 2014. The employees exercised their options for 22,500 shares only. The remaining options lapsed. The company closes its books on 31st March every year. Pass Journal entries. [8]

Answer:

Date	Particulars	Dr. (₹)	Cr. (₹)
01.04.12	Employee Compensation Expense A/c Dr. To Employee Stock Options Outstanding A/c (Being grant of 25000 stock options to employees at ₹100 when market price is ₹ 425)	81,25,000	 81,25,000
(16.10.12 to 15.03.14)	Bank A/c Dr. Employee Stock Options Outstanding A/c Dr. To Equity Share Capital A/c To Security Premium A/c (Being allotment to employees of 22500 equity shares of ₹10 each at a premium of ₹415 per share in exercise of stock options by employees)	22,50,000 73,12,500	 2,25,000 93,37,500
16.03.14	Employee Stock Options Outstanding A/c Dr. To Employee Compensation Expense A/c (Being entry for lapse of stock options for 2500 Shares)	8,12,500	 8,12,500
31.03.14	Profit & Loss A/c Dr. To Employee compensation expense A/c (Being transfer of employee compensation Expense to profit and loss account)	73,12,500	 73,12,500
Note: Employee stock options outstanding will appear in the Balance Sheet as part of Net Worth or Shareholders' Equity.			

(b) Sonic Ltd. incorporated on 1st June, 2015 issued a prospectus inviting applications for 10,00,000 equity shares of ₹10 each. The whole issue was fully underwritten by four underwriters:

	S	T	U	V
Underwriter	**4,00,000 shares**	**3,00,000 shares**	**2,00,000 shares**	**1,00,000 shares**

Applications were received for 9,00,000 shares of which marked applications were as follows:

	S	T	U	V
Underwriter	**4,40,000 shares**	**1,80,000 shares**	**2,20,000 shares**	**20,000 shares**

Find out the liability of each underwriter individually. [7]

Answer:

Statement of Underwriters' Liability

Particulars	S	T	U	V	TOTAL
Gross Liability	4,00,000	3,00,000	2,00,000	1,00,000	10,00,000
Less: Marked Applications	4,40,000	1,80,000	2,20,000	20,000	8,60,000
Balance Left	(40,000)	1,20,000	(20,000)	80,000	1,40,000
Less: Unmarked Application	16,000	12,000	8,000	4,000	40,000
Applications in the ratio of gross liability	(56,000)	1,08,000	(28,000)	76,000	1,00,000
Division of surplus of S and U to T and V in the ratio of (3:1)	56,000	(63,000)	28,000	(21,000)	0
Net Liability	NIL	45,000	NIL	55,000	1,00,000

6. (a) From the following information, prepare the relevant Notes to Accounts:

	₹ lakhs
Sundry Creditors	**40.00**
Bills Payables	**20.00**
Bank Overdraft	**10.00**
Unpaid Dividend	**3.00**
Outstanding Expenses	**3.00**
Calls-in-Advance	**2.00**
Provision for Tax	**200.00**

[6]

Answer:

1. Trade Payables

	₹ lakhs
Sundry Creditors	40.00
Bills Payables	20.00
	60.00

2. Other Current Liabilities

	₹ lakhs
Bank Overdraft	10.00
Unpaid Dividend	3.00
Outstanding Expenses	3.00
Calls-in-Advance	2.00
	18.00

3. Short – term Provision

	₹ lakhs
Provision for Tax	200
	200

(b) Tarun Ltd. has taken an asset on lease from Barun Ltd for a period of 3 years. Annual Lease rental are ₹8 lakhs payable at the end of every year. The residual value guaranteed by Tarun is ₹3 lakhs whereas Barun expects the estimated salvage value to be ₹6 lakhs at the end of the lease term. If the fair value of the asset at the lease inception is ₹15 lakhs and the interest rate implicit in the lease is 18%, compute the Net Investment in the lease from the viewpoint of Barun Ltd and the annual finance income. [9]

Answer:

Minimum Lease Payment (MLP) = ₹8 Lakhs x 3 years = ₹24,00,000
Guaranteed Residual Value (GRV) = ₹3,00,000

MLP from the viewpoint of the Lessor (Barun) = MLP + GRV = ₹27,00,000

Unguaranteed Residual Value (URV) = Total Residual Value – GRV = ₹3,00,000

Gross Investment in the Lease = MLP for Lessor + URV = ₹30,00,000

PV of MLP, GRV and URV (working) = ₹21,04,600

Unearned Finance Income = ₹30,00,000 – ₹21,04,600 = ₹8,95,400

Net Investment in the Lease = ₹30,00,000 - ₹8,95,400 = ₹21,04,600

Working:

Present Value (PV) of gross Investment in the Lease is computed as under –

PV of MLP = ₹8,00,000 x PVF at 18% for 3 years = ₹8,00,000 x (0.847+0.718+0.609)

= ₹17,39,200

PV of (GRV+URV) = ₹6,00,000 x PVF at 18% for year 3 = ₹6,00,000 x 0.609

= ₹3,65,400

Total of the above

= ₹21,04,600

Recognition of finance Income by Lessor

Year	Net Investment in the Lease = Receivable	Finance Income at 18% on NI	Total Lease Payments received from Lessee	Balance Reduction in Receivable (i.e. Principle)
(1)	**(2)**	**(3)= (2) x 18%**	**(4)**	**(5)= (4) – (3)**
1	₹21,04,600	₹21,04,600 x 18% = 3,78,828	₹8,00,000	₹8,00,000 - ₹3,78,828 =₹4,21,172
2	₹21,04,600 - ₹4,21,172 =₹16,83,428	₹16,83,428 x 18% = ₹3,03,017	₹8,00,000	₹8,00,000 - ₹3,03,017 = ₹4,96,983
3	₹16,83,428 - ₹4,96,983 = ₹11,86,445	₹11,86,445 x 18% = ₹2,13,560	₹8,00,000	₹8,00,000 - ₹2,13,560 = ₹5,86,440
3 (end)	₹11,86,445 - ₹5,86,440 = ₹6,00,005	Nil	₹6,00,000	Nil (difference ₹5 due to R/Off)

7. **Following are the summarized Balance Sheets of Poova Limited and Pouru Limited as at 31st March, 2015:**

(₹ in lakhs)

Liabilities	Poova Ltd.	Pouru Ltd.	Assets	Poova Ltd.	Pouru Ltd.
Share capital:			**Goodwill**	**40**	**---**
Equity shares of ₹ 100 each	**3,000**	**2,000**	**Other fixed assets**	**3,200**	**1,520**
9% Preference shares of ₹ 100 each	**1,000**	**800**	**Trade receivables**	**1,250**	**880**
General reserve	**250**	**340**	**Inventory**	**660**	**1,360**
Profit and loss account	**---**	**30**	**Cash at bank**	**52**	**260**
12% Debentures of ₹100 each	**1,000**	**400**	**Own debenture (₹ 100 each) (Nominal value ₹ 40,00,000)**	**38**	**---**
Trade payables	**810**	**450**	**Discount on issue of debentures**	**6**	**---**
			Profit and loss account	**814**	**---**
	6,060	**4,020**		**6,060**	**4,020**

On 1.4.2015, Poova Ltd. adopted the following scheme of reconstruction:

a. **Each equity share shall be sub-divided into 10 equity shares of ₹ 10 each fully paid up. 50% of the equity share capital would be sacrificed to the Company.**
b. **Preference dividends are in arrear for 3 years. Preference shareholders agreed to waive 90% of the dividend claim and accept payment for the balance.**
c. **Own debentures of ₹ 25,00,000 were sold at ₹ 98 per debenture cum-interest and remaining own debentures were cancelled.**
d. **Debenture holders of ₹ 4.8 crores agreed to accept one machinery of book value of ₹ 5 crores in full settlement.**

e. **Trade payables, trade receivables and inventory were valued at ₹ 7 crores; ₹ 11 crores and ₹ 5.90 crores respectively. The goodwill, discount on issue of debentures and Profit and Loss (Dr.) are to be written off.**

f. **The Company paid ₹ 4 lakhs as penalty to avoid capital commitments of ₹ 30 lakhs.**

On 2.4.2015 a scheme of absorption was adopted. Poova Ltd. would take over Pouru Ltd. The purchase consideration was fixed as below:

(a) **Equity shareholders of Pouru Ltd. will be given 50 equity shares of ₹ 10 each fully paid up, in exchange for every 5 shares held in Pouru Ltd.**

(b) **Issue of 9% preference shares of ₹ 100 each in the ratio of 4 preference shares of Poova Ltd. for every 5 preference shares held in Pouru Ltd.**

(c) **Issue of one 12% debenture of ₹ 100 each of Poova Ltd. for every 12% debentures in Pouru Ltd.**

You are required to give Journal entries in the books of Poova Ltd. [15]

Answer:

In the Books of Poova Ltd.

(₹ In lakhs)

Date	Particulars	Dr. Amount (₹)	Cr. Amount (₹)
1.4.2015	Equity Share Capital A/c Dr. To Equity Share Capital A/c (Being sub-division of one share of ₹ 100 each into 10 shares of ₹ 10 each)	3,000	 3,000
	Equity Share Capital A/c Dr. To Capital Reduction A/c (Being reduction of Equity Capital by 50%)	1,500	 1,500
	Capital Reduction A/c Dr. To Bank A/c (Being payment in cash of 10% of arrear of preference dividend)	27	 27
	Bank A/c Dr. To Own Debentures A/c To Capital Reduction A/c (Being profit on sale of own debentures of ₹75,000 transferred to Capital Reduction A/c)	24.5	 23.75 0.75
	12% Debentures A/c Dr. To Own Debentures A/c To Capital Reduction A/c (Being profit on cancellation of own debentures transferred to Capital Reduction A/c)	15	 14.25 0.75
	12% Debentures A/c Dr. Capital Reduction A/c Dr. To Machinery A/c (Being machinery taken up by debenture holders for ₹ 4.80 Cr.)	480 20	 500
	Trade Payables A/c Dr. Capital Reduction A/c (balancing figure) Dr. To Trade Receivables A/c To Inventory A/c (Being assets and liabilities revalued)	110 110	 150 70
	Capital Reduction A/c Dr. To Goodwill A/c To Discount on Debentures A/c	860	 40 6

	To Profit and Loss A/c (Being the above assets written off)		814
	Capital Reduction A/c Dr. To Bank A/c (Being penalty paid for avoidance of capital commitments)	4	 4
	Capital Reduction A/c Dr. To Capital Reserve A/c (Being the credit balance in Capital Reduction A/c transferred to Capital Reserve)	480.50	 480.50
2.4.2015	Business Purchase A/c Dr. To Liquidators of Pouru Ltd. (Being the purchase consideration payable to Pouru Ltd.)	2,640	 2,640
	Fixed Assets A/c Dr. Inventory A/c Dr. Trade Receivables A/c Dr. Cash at Bank A/c Dr. To Trade Payables A/c To 12% Debentures A/c of Pouru Ltd. To Profit and Loss A/c To General Reserve A/c To Business Purchase A/c (Being the takeover of all assets and liabilities of Pouru Ltd. by Poova Ltd.)	1,520 1,360 880 260	 450 400 30 500 2,640
	Liquidators of Pouru Ltd. A/c Dr. To Equity Share Capital A/c To 9% Preference Share Capital A/c (Being the purchase consideration discharged)	2,640	 2,000 640
	12% Debentures of Pouru Ltd. A/c Dr. To 12% Debentures A/c (Being Poova Ltd. issued their 12% Debentures in against of every Debentures of Pouru Ltd.)	400	 400

Working Note:

1. Arrear dividend to Preference Shareholders
   Preference Share Capital ₹ 10,00,00,000 @ 9% will yield dividend of ₹ 90,00,000 per year and for 3 years = ₹ 2,70,00,000. Out of this only 10% is paid and the balance is waived off. Hence, amount paid = ₹ 27,00,000.

2. Profit on redemption of own debentures
   Own Debentures with Nominal Value of ₹ 25,00,000 sold for ₹ 98 per Debenture
   = ₹ 24,50,000
   Book Value = (38Lakhs/40Lakhs) x 25Lakhs= ₹ 23.75Lakhs
   Profit on own Debentures sold = ₹ 24.50Lakhs-23.75Lakhs= ₹ 0.75Lakhs
   Balance Own Debentures = ₹ 38Lakhs-23.75= ₹ 14.25Lakhs

3. Purchase Consideration:

Equity share capital 20,00,000 x $\frac{50}{5}$ x ₹10	₹2,000 Lakhs
9% Preference share capital 8,00,000 x $\frac{4}{5}$ x 100	₹640 Lakhs
	₹2,640 Lakhs

Section – C

III. Answer any two questions out of the following four questions [2×15=30]

8. (a) "Some material mis-statements remain unreported by Auditors."— Comment. [7]
(b) How would you determine the materiality of an item, while conducting audit. [8]

Answer:

(a) The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements. In general, misstatements, including omissions, are considered to be material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements. Judgments about materiality are made in the light of surrounding circumstances, and are affected by the auditor's perception of the financial information needs of users of the financial statements, and by the size or nature of a misstatement, or a combination of both. The auditor's opinion deals with the financial statements as a whole and therefore the auditor is not responsible for the detection of misstatements that are not material to the financial statements as a whole.

Risk of material misstatement - The risk that the financial statements are materially misstated prior to audit. This consists of two components, described as follows at the assertion level:

(i) Inherent risk - The susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.
(ii) Control risk- The risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.

(b) Concept of "Materiality" in planning and performing the audit —

Materiality is one of the basic fundamental concepts in the process of Accounting and Auditing. It is a continuous process and covers in its ambit all the stages from recording to classification and presentation. An auditor has to constantly judge whether a particular item or transaction is material or not.

The main factors to be considered for determining materiality of an item are:

(i) Individually: It may be determined individually. E.g., a payment of ₹1000 may be material in a small business, but even ₹1 lac could be immaterial for a big business entity.

(ii) Aggregate: It may be determined in aggregate. E.g., total income from investment in mutual funds could be more material than looking into each individual investment.

(iii) Legal Considerations: It depends on the statutory or legal considerations. E.g., where the terms of appointment of a whole time director are not according to law, the remuneration paid to him is a material item even if the financial implication is not much.

(iv) Legal Definition: It may be defined or described in law itself. E.g., Schedule III requires separate disclosure of items of all expenses exceeding 1% of turnover or to write off capital assets purchased for less than ₹5000.

(v) Relative overall impact: It may depend on the relative degree of relevance to the overall accounts or the group, or class of transactions to which it pertains. E.g., short recoveries from debtors.

(vi) Qualitative: It may be qualitative and not often reckoned with respect to quantitative details alone.E.g, improper disclosure of an accounting policy in the Notes to the Annual Financial Statements may affect economic decisions.

(vii) Insignificant quantity but special context: It maybe of an insignificant quantity otherwise, but material in special circumstances. E.g., rounding off to the nearest rupee the fraction of 0.666 as 0.67 in computer software. It may be material in future due to cumulative effect even if insignificant now.

9. (a) Mr. Raghav, who is a chartered accountant, wants to conduct the audit of Ram-Shyam Limited. State the disqualifications that would make him ineligible for the post [10]

(b) What types of analysis are covered by analytical procedures? [5]

Answer:

(a) Appointment of Mr. Raghav as an Auditor.

The following persons shall not be eligible for appointment as an auditor of a company, namely:—

(a) a body corporate other than a limited liability partnership registered under the Limited Liability Partnership Act, 2008;

(b) an officer or employee of the company;

(c) a person who is a partner, or who is in the employment, of an officer or employee of the company;

(d) a person who, or his relative or partner—

  (i) is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company.

  (ii) Provided that the relative may hold security or interest in the company of face value not exceeding one thousand rupees or such sum as may be prescribed;

  (iii) is indebted to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company, in excess of such amount as may be prescribed; or

(iv) has given a guarantee or provided any security in connection with the indebtedness of any third person to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company, for such amount as may be prescribed;

(e) a person or a firm who, whether directly or indirectly, has business relationship with the company, or its subsidiary, or its holding or associate company or subsidiary of such holding company or associate company of such nature as may be prescribed;

(f) a person whose relative is a director or is in the employment of the company as a director or key managerial personnel;

(g) a person who is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such persons or partner is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies;

(h) a person who has been convicted by a court of an offence involving fraud and a period of ten years has not elapsed from the date of such conviction;

(i) any person whose subsidiary or associate company or any other form of entity, is engaged as on the date of appointment in consulting and specialised services as provided in section 144.

If Mr. Raghav possess any of the above disqualifications he would not be eligible for the post of an auditor in Ram-Shyam Ltd.

(b) Analytical procedures include the analysis or comparisons of the entity's financial information with, for example:

- Comparable information for prior periods.
- Anticipated results of the entity, such as budgets or forecasts, or expectations of the auditor, such as an estimation of depreciation.
- Similar industry information, such as a comparison of the entity's ratio of sales to accounts receivable with industry averages or with other entities of comparable size in the same industry.

Analytical procedures also include the analysis of relationships, for example:

- Among elements of financial information that would be expected to conform to a predictable pattern based on the entity's experience, such as gross margin percentages.
- Between financial information and relevant non-financial information, such as payroll costs to number of employees.

10. (a) What are the matters to be specially considered while conducting the audit of a Partnership firm? [9]

(b) State the objectives of cost audit from the point of view of Government. [6]

Answer:

(a) Special Points in Audit of a Partnership Firm: Matters which should be specially considered in the audit of accounts of a partnership firm are as under:

(1) Confirming that the letter of appointment, signed by a partner, duly authorised, clearly states the nature and scope of audit contemplated by the partners, specially the limitation, if any, under which the auditor shall have to function.

(2) Examine the partnership deed signed by all partners and its registration with the registrar of firms. Also ascertain from the partnership deed about capital contribution, profit sharing ratios, interest on capital contribution, powers and responsibilities of the partners, etc.
(3) Studying the minute book, if any, maintained to record the policy decision taken by partners specially the minutes relating to authorisation of extraordinary and capital expenditure, raising of loans, purchase of assets, extraordinary contracts entered into and other such matters which are not of a routine nature.
(4) Verifying that the business in which the partnership is engaged is authorised by the partnership agreement; or by any extension or modification thereof agreed to subsequently.
(5) Examining whether books of account appear to be reasonable and are considered adequate in relation to the nature of the business of the partnership.
(6) Verifying generally that the interest of no partner has suffered prejudicially by an activity engaged in by the partnership which, it was not authorised to do under the partnership deed or by any violation of a provision in the partnership agreement.
    (a) Confirming that a provision for the firm's tax payable by the partnership has been made in the accounts before arriving at the amount of profit divisible among the partners. Also see various requirements of legislations applicable to the partnership firm like Section 44(AB) of the Income-tax Act, 1961 have been complied with.
    (b) Verifying that the profits and losses have been divided among the partners in their agreed profit-sharing ratio.

(b) The objective of Cost audit from the point of view of government:

(i) To ensure whether the national resources are prudently and optimally used.
(ii) To reduce cost of production of commodities and regularize their distribution.
(iii) To determine whether particular industry should be given subsidy/grants.
(iv) To determine whether particular industry should be protected from external competition.
(v) To make comparisons of cost parameters of different firms manufacturing same product.
(vi) To assess the costs of the same product on different regions so as to decide to grant incentives etc.
(vii) To fix the maximum price of a commodity.
(viii) To devise, apply and evaluate cost control measures.