# 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]**

**(a) Net profit for the year 2015-16 ₹ 50,00,000 and 2016-17 ₹1,50,00,000. No. of equity shares outstanding until 31st Dec, 2016: 20,00,000. Bonus issue on 1st January, 2017 was one equity share for each equity share outstanding on 31st Dec, 2016.**
**Calculate Basic Earnings per Share.**

**Answer:**

$$\text{EPS for 2016 – 2017} = \frac{₹1,50,00,000}{(20,00,000 + 20,00,000)} = ₹3.75$$

$$\text{Adjusted EPS for 2015 – 2016} = \frac{₹50,00,000}{40,00,000} = ₹1.25.$$

**(b) Mitra Limited took over assets of ₹70,92,000 and liabilities of ₹9,70,000 of Friends Enterprises at an agreed value of ₹67,30,000. Give the necessary journal entry to record the purchase of business in the books of Mitra Limited.**

**Answer:**

**Journal Entry**

| Date | Particulars | L.F. | Debit (₹) | Credit (₹) |
|---|---|---|---|---|
| | Sundry Assets A/c Dr.<br>Goodwill A/c(Balancing figure) Dr.<br>To Sundry Liabilities A/c<br>To Friends Enterprises A/c<br>(Being the purchase of business of Friends Enterprises) | | 70,92,000<br>6,08,000 | <br><br>9,70,000<br>67,30,000 |

**(c) Define Integral Foreign Operation.**

**Answer:**

It is an operation which is managed and financed in such a manner that any change in the exchange rate has almost immediate effects on the cash flow of the reporting enterprise. Further they are also seemed as an extension of the operation of the reporting enterprise. Example: Foreign branch.

**(d) A company issued 20,000 15% debentures of ₹ 100 each at par redeemable at a premium of 15%.**
**After 8 years the company served notice of redemption and redeemed all debentures as per the terms of issue. You are required to make entry for the time of issue of debentures only.**

**Answer:**

| Particulars | Dr. (₹'000 ) | Cr. (₹'000) |
|---|---|---|
| Bank A/c Dr. | 2,000 | |
| Loss on issue of debentures A/c Dr. | 300 | |
| To 15% Debentures A/c | | 2,000 |

| | | |
|---|---|---|
| To Premium on Redemption A/c<br>(being, 20,000 15% Debentures of ₹100 each issued at par which are redeemable at a premium of 15%) | | 300 |

**(e) During the year 2013-14, Purvi Limited received a grant from the Government of India amounting to ₹35 lakh towards purchase of a piece of land for ₹140 lakh.**
**You are required to show the accounting treatment of the above transaction in the books of Purvi Limited, as per AS-12.**

**Answer:**

As per AS-12, accounting for Government Grants related to non- depreciable assets should be credited to capital reserve.

Thus, in the Books of Purvi Limited: (₹ In Lakhs)

| Accounting entries: | | ₹ | ₹ |
|---|---|---|---|
| **(i) On Purchase of Land** | | | |
| Land A/c | Dr. | 140 | |
| To Bank A/c | | | 140 |
| **(ii) On receipt of Govt. Grant** | | | |
| Bank A/c | Dr. | 35 | |
| To Capital Reserve A/c | | | 35 |

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

| Column 'A' | | Column 'B' | |
|---|---|---|---|
| **1.** | **Treatment of Voluntary Retirement Scheme Payments** | **A.** | **Capital Reserve** |
| **2.** | **Balance of Forfeited Shares A/c** | **B.** | **Amalgamation** |
| **3.** | **Interest and Dividend Received** | **C.** | **AS-26** |
| **4.** | **Pooling of Interest Method** | **D.** | **AS-15** |
| **5.** | **Recognition of an Intangible Asset** | **E.** | **Investing Activities of Cash Flow** |

**Answer:**

| Column 'A' | | Column 'B' | |
|---|---|---|---|
| 1. | Treatment of Voluntary Retirement Scheme Payments | D. | AS – 15 |
| 2. | Balance of Forfeited Shares A/c | A. | Capital Reserve |
| 3. | Interest and Dividend Received | E. | Investing Activities of Cash Flow |
| 4. | Purchase Method | B. | Amalgamation |
| 5. | Recognition of an Intangible Asset | C. | AS-26 |

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

**(a) Checks while auditing splitting of shares**

**Answer:**

**Checks while auditing splitting of shares:**

- Confirm that alteration was authorised by articles.

- Verify the minutes of the Board meeting and ordinary resolution passed in the general meeting in which the approval of members is obtained.
- Verify that alteration had been effected in copies of Memorandum, Articles, etc.
- Verify that proper accounting entries have been passed. Register of members may also be checked to see that the necessary alteration have been effected therein.

**(b) Distinction between Financial Audit and Cost Audit**

**Answer:**

Following are distinctions between financial (statutory) audit and cost audit.

- All companies must keep proper books of account, while keeping cost accounting records is compulsory only in case of specified companies.
- Financial Audit is compulsory every year, while cost audit has to be carried out only when Cost Audit Order is issued by Central Government.
- Financial audit is done by practising Chartered Accountant. Cost audit can be done by practicing Cost accountant.
- Financial Auditor is appointed in AGM, while Cost Auditor is appointed by Board of Directors.
- Report of Financial Auditor has to be submitted to members, which has to be adopted in the AGM. The Cost Audit report has to be submitted to Central Government, with a copy to the Company.

**(c) Comment on Submission of Cost Audit Report**

**Answer:**

The Cost Audit Report should be submitted to Board of Directors of the company - proviso to Section 148(5) of the 2013 Act.

After such submission, the company shall furnish the report to Central Government within 30 days, along with full information and explanation on every reservation or qualification contained in the report - Section 148(6) of the 2013 Act.

The information and explanation is required to be submitted electronically.
After considering the report of cost auditor and explanations given by the company, the Central Government can ask for further information and explanations. The company shall submit the same within prescribed time. [Section 148(7) of the 2013 Act].

**(d) Re-appointment of an auditor**

**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.

**(e) 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.

## Section – B

**Answer any Three Questions [3×15=45]**

**4. (a) The following balances were shown in the Balance Sheet of A Limited as at 31st March, 2016:**

| | ₹ |
|---|---|
| **8,00,000 Equity Shares of ₹10 each fully paid up** | **80,00,000** |
| **50,000, 8% Preference Shares of ₹100 each ₹80 paid up** | **40,00,000** |
| **Capital Reserve** | **35,00,000** |
| **General Reserve** | **80,00,000** |
| **Securities Premium** | **70,00,000** |
| **Profit & Loss Account** | **52,00,000** |
| **12% Debentures** | **10,00,000** |
| **Non-Current Investment at cost** | **65,00,000** |
| **Cash and Bank** | **92,00,000** |

**Additional Information:**

**(i) The company passed a resolution to buy-back 20% of its equity capital @ ₹35 per share. For this purpose, it sold its investments of ₹30 lakhs for ₹28 lakhs.**

**(ii) The company redeemed the preference shares at a premium of 25%.**

**(iii) Included in its investments were 'Investments in own debentures' costing ₹10 lakhs (face value ₹11.50 lakhs). These debentures were cancelled.**

**You are required to pass necessary journal entries in the books of the company for above. [10]**

**Answer:**

**Journal Entries in the Books of A Limited**

**(₹ in Lakhs)**

| | Particulars | Dr. | Cr. |
|---|---|---|---|
| 1. | Bank A/c Dr.<br>Profit and Loss A/c Dr.<br>To Investment A/c<br>(Being investment sold for the purpose of buy-back of Equity Shares) | 28<br>2 | <br><br>30 |
| 2. | Preference Share Final Call A/c Dr.<br>To 8% Preference Share Capital A/c | 10 | <br>10 |

| | | | |
|---|---|---|---|
| | (Being final call money due) | | |
| 3. | Bank A/c Dr.<br>To Preference Share Final Call A/c<br>(Being call money received) | 10 | <br>10 |
| 4. | 8% Preference Share Capital A/c Dr.<br>Premium on Redemption of Preference Shares A/c Dr.<br>To Preference Shareholders A/c<br>(Being redemption of preference share capital at premium of 25%.) | 50<br>12.50 | <br><br>62.50 |
| 5. | Preference Shareholders A/c Dr.<br>To Bank A/c<br>(Being payment made to preference shareholders) | 62.50 | <br>62.50 |
| 6. | General Reserve A/c Dr.<br>To Capital Redemption Reserve A/c<br>(Refer Note)<br>(Being creation of capital redemption reserve) | 66 | <br>66 |
| 7. | Equity Share Capital A/c Dr.<br>Securities Premium A/c Dr.<br>(Premium payable on buy-back)<br>To Equity Shares Buy-back A/c<br>(Being the amount due on buy-back of equity shares) | 16<br>40 | <br><br><br>56 |
| 8. | Equity Shares Buy-back A/c Dr.<br>To Bank A/c<br>(Being payment made for buy-back of equity shares) | 56 | <br>56 |
| 9. | 12% Debentures A/c Dr.<br>To Own Debentures A/c<br>To Capital Reserve Ac (Profit on cancellation)<br>(Being own debentures cancelled at profit) | 11.5 | <br>10<br>1.50 |
| 10. | Securities Premium A/c Dr.<br>To Premium on Redemption of Preference Shares A/c<br>(Being premium on redemption of preference shares adjusted through securities premium) | 12.50 | <br>12.50 |

**Note:** Transfer to Capital Redemption Reserve A/c as:

| | ₹ |
|---|---|
| For Redemption of P. S. Capital | 50 lakhs |
| For Buy-back of Equity Shares | 16 Lakhs |
| Total | 66 lakhs |

**(b) The following items appear in the Trial Balance of Nupur Ltd. as at 31st March, 2015:**

| Particulars | ₹ |
|---|---|
| **1. Revenue from Operations** | **24,00,000** |
| **2. Other Income** | **1,00,000** |
| **3. Expenses other than Interest** | **3,80,000** |
| **4. General Reserve (as on 1st April, 2014)** | **1,30,000** |

**5. Profit and Loss Account (as on 1.4.2014) ₹3,28,000. The recommendation of the company's Board of Directors include equity dividend of 15% (Including Interim Dividend of ₹ 80,000). Transfer to Debenture Redemption Reserve @ 50% of Debentures and Transfer to General Reserve @ 5%. (Assume Corporate Tax 30% and Dividend Distribution Tax @ 20%).**

6. **12%, 10,000 Debentures of ₹ 100 each fully paid up**
7. **14%, 5,000 Preference Shares of ₹ 100 each fully paid up**
8. **6,000 Equity Shares of ₹ 100 each**
9. **8,000 Equity Shares ₹ 100 each, ₹ 25 paid up**

**Required: Show the Profit and Loss. [5]**

**Answer:**

Nupur Ltd. Statement of Profit and Loss for the year ended 31st March, 2015

| Particulars | Note No. | (₹ in lacs) |
|---|---|---|
| I. Revenue from Operations | | 24 |
| II. Other Income | | 1 |
| III. Total Revenue [I + II] | | 25 |
| IV. Expenses: | | |
| Finance Costs | | 1.2 |
| Other Expenses | | 3.8 |
| Total Expenses | | 5.0 |
| V. Profit before Tax(III - IV) | | 20 |
| VI. Tax Expense [30% of ₹ 20 lacs] | | (6) |
| VII. Profit for the period | | 14 |
| Basic Earnings per Equity Share: | | |
| = [Profit for the period - Pref. Dividend] /No. of Equity Shares | | |
| = (14 - 0.70)/8000 = ₹ 166.25 | | |

6. **Following Balances are provided by the Mayank Ltd. for the year ended 31st March, 2015 and 2016:**

| **Particulars** | **31.03.2015 ₹** | **31.03.2016 ₹** |
|---|---|---|
| **Equity Share Capital** | **120,00,000** | **140,00,000** |
| **General Reserve** | **74,00,000** | **89,00,000** |
| **Profit & Loss A/c** | **42,00,000** | **60,00,000** |
| **11% Debentures** | **100,00,000** | **60,00,000** |
| **Goodwill** | **20,00,000** | **16,00,000** |
| **Land & Building** | **140,00,000** | **130,00,000** |
| **Plant & Machinery** | **120,00,000** | **132,00,000** |
| **Investment (Non trading)** | **48,00,000** | **44,00,000** |
| **Creditors** | **37,00,000** | **43,00,000** |
| **Provision for tax** | **25,50,000** | **38,40,000** |
| **Proposed Dividend** | **18,00,000** | **25,20,000** |
| **Stock** | **80,00,000** | **77,00,000** |
| **Debtors** | **57,60,000** | **83,00,000** |
| **Cash at Bank** | **17,60,000** | **18,60,000** |
| **Prepaid Expenses** | **3,00,000** | **2,20,000** |

**Additional Information:**

(i) **Investment were sold during the year for ₹7,00,000.**

(ii) **During the year an old machine costing ₹16,00,000 was sold for ₹7,20,000. Its written down value was ₹9,00,000.**

**(iii) Depreciation charged on plant and machinery @20% on the opening balance.**

**(iv) There was no purchase or sell of land and building during the year.**

**(v) Provision for tax made during the year was ₹32,20,000.**

**(vi) During the year premium on redemption of debentures ₹4,00,000 was written-off.**

**You are required to prepare a statement showing the net cash flow from the operating activities. [10]**

**Answer:**

Statement Showing Net Cash Flow from Operating Activities
for the year ending 31st March, 2016

| **Particulars** | ₹ | ₹ |
|---|---|---|
| Profit & Loss A/c as on 31.03.2016 | | 60,00,000 |
| Less: Profit &Loss A/c as on 31.03.2015 | | 42,00,000 |
| | | 18,00,000 |
| Add: Transfer to General Reserve | 15,00,000 | |
| Provision for tax | 32,20,000 | |
| Proposed Dividend | 25,20,000 | 72,40,000 |
| Profit before tax | | 90,40,000 |
| Adjustment for Depreciation: | | |
| Land & Building | 10,00,000 | |
| Plant & Machinery | 24,00,000 | 34,00,000 |
| Profit on sale of Investment (7,00,000 - 4,00,000) | | (3,00,000) |
| Loss on sale of Plant & Machinery | | 1,80,000 |
| Goodwill written-off | | 4,00,000 |
| Premium on redemption of debentures written-off | | 4,00,000 |
| Operating Profit before Working Capital Changes | | 1,31,20,000 |
| W. C. Changes: | | |
| Decrease in Prepaid Expenses | | 80,000 |
| Decrease in Stock | | 3,00,000 |
| Increase in Debtors | | (25,40,000) |
| Increase in Creditors | | 6,00,000 |
| Cash generated from operations | | 1,15,60,000 |
| Income Tax paid | | (19,30,000) |
| Net Cash Inflow from Operating Activities | | 96,30,000 |

**Working Notes:**

**Provision for Tax Account**

**Dr.** **Cr.**

| **Particulars** | ₹ | **Particulars** | ₹ |
|---|---|---|---|
| To Bank A/c (Balancing figure) | 19,30,000 | By Balance b/d | 25,50,000 |
| To Balance c/d | 38,40,000 | By Profit & Loss A/c | 32,20,000 |
| | 57,70,000 | | 57,70,000 |

**Investment Account**

**Dr.** **Cr.**

| Particulars | ₹ | Particulars | ₹ |
|---|---|---|---|
| To Balance b/d | 48,00,000 | By Bank A/c (sale) By | 7,00,000 |
| To Profit & Loss A/c (profit) | 3,00,000 | Balance c/d | 44,00,000 |
| | 51,00,000 | | 51,00,000 |

**(b) A Ltd. purchased fixed assets costing ₹ 7,500 lakhs on 1.1.15 and the same was fully financed by foreign currency loan (U.S. Dollars) payable in three annual equal installments. Exchange rates were 1 Dollar = ₹ 62.50 and ₹ 65.00 as on 1.1.15 and 31.12.15 respectively. First installment was paid on 31.12.15. The entire difference in foreign exchange has been capitalized.**
**You are required to state, how these transactions would be accounted for. [5]**

**Answer:**

As AS 11 'The Effects of Changes in Foreign Exchange Rates', exchange differences arising on the settlement of monetary items or on reporting an enterprise's monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, should be recognized as income or expenses in the period in which they arise. Thus exchange differences arising on repayment of liabilities incurred for the purpose of acquiring fixed assets are recognized as income or expense.

Calculation of Exchange Difference:

$$\text{Foreign currency loan} = \frac{₹\,7,500\text{ lakhs}}{₹\,62.50} = 120\text{ lakhs US Dollars}$$

Exchange difference = ₹120 lakhs US Dollars × (65.00 – 62.50)

= ₹ 300 lakhs (including exchange loss on payment of first installment)

Therefore, entire loss due to exchange differences amounting ₹ 300 lakhs should be charged to profit and loss account for the year.

**7. (a) Prithvi Ltd. issued 40,000 Shares which are underwritten as follows:**

**Mr. A — 24,000; Mr. B — 10,000 and Mr. C — 6,000 Shares.**

- **The Underwriters made applications for firm underwriting as under:**
  **Mr. A — 3,200 Shares; Mr. B — 1,200 Shares; and Mr. C — 4,000 Shares.**
- **The total subscriptions excluding Firm Underwriting but including marked applications were for 20,000 Shares.**
- **The marked applications were: Mr. A — 4,000 Shares; Mr. B — 8,000 Shares and Mr. C — 2,000 Shares.**
- **Show the allocation of liability of the underwriters. [8]**

**Answer:**

| Particulars | Mr. A | Mr. B | Mr. C | Total |
|---|---|---|---|---|
| Gross Liability | 24,000 | 10,000 | 6,000 | 40,000 |
| (-) Firm Application | (3,200) | (1,200) | (4,000) | (8,400) |
| (-) Marked Application | (4,000) | (8,000) | (2,000) | (14,000) |
| (-) Unmarked Application | (3,600) | (1,500) | (900) | (6,000) |
| Net liability under the Contract | 13,200 | (700) | (900) | 11,600 |
| (+)/(-) Surplus in Gross Liability Ratio | (1,600) | 700 | 900 | — |
| Liability of the Underwriter | 11,600 | — | — | 11,600 |
| (+) Firm Application | 3,200 | 1,200 | 4,000 | 8,400 |
| Total Liability of the Underwriter | 14,800 | 1,200 | 4,000 | 20,000 |

Unmarked Applications = 6,000 i.e. Total Applications 20,000 — Marked Applications (4,000 + 8,000 + 2,000 = 14,000). These are distributed in the ratio of Gross Liability i.e. 12:5:3.

**(b) M Ltd. has the following business/geographical segments.**

**Examine which of these are reportable Segments under AS - 17.**

**(Information in ₹000's)**

| Segments | Revenue | Profit/ (Loss) | Assets |
|---|---|---|---|
| **A** | **19,200** | **3,500** | **8,200** |
| **B** | **600** | **360** | **900** |
| **C** | **200** | **140** | **900** |

**[7]**

**Answer:**

| Particulars (₹ in Lakhs) | A | B | C | Total |
|---|---|---|---|---|
| 1. Segment Revenue | 19,200 | 600 | 200 | 20,000 |
| 2. Percentage of Segment Revenue | 96% | 3% | 1% | 100% |
| 3. Segment Result i.e. Profit | 3,500 | 360 | 140 | 4,000 |
| 4. Percentage of Segment Result, absolute amount of Profit or Loss, whichever is higher i.e. percentage of 2,000 | 87.5% | 9% | 3.5% | 100% |
| 5. Segment Assets | 8,200 | 900 | 900 | 10,000 |
| 6. Percentage of Segment Assets | 82% | 9% | 9% | 100% |
| 7. Reportable Segment | Yes | No | No | |
| 8. Criteria satisfied | All | Nil | Nil | |

**A. Single Segment Principle:** Disclosure of Segment Information as per AS - 17 is not required, if there is not more than one business / geographical segment. This is because, the relevant information is available from the Balance Sheet and Profit & Loss Account itself.

**B. Analysis and Conclusion**: Since Segments B and C do not meet the reportable segment criteria and also] 75% condition is satisfied by Segment A alone, only Segment A is identified as a Reportable Segment.

8. **(a) The following particulars relate to a Varahamihira Pipes Limited which has gone into voluntary liquidation on 31.3.2014.**

**Share Capital issued:**
**6,000 Preference share of ₹ 100 each fully paid up.**
**45,000 Equity Shares of ₹ 10 each fully paid up.**
**20,000 Equity Shares of ₹ 10 each, 7 paid up.**

**Assets realised ₹ 14,00,000 excluding the amount realized by sale of securities held by partly secured creditors.**

| Particulars | Amount (₹) |
|---|---|
| **Preferential Creditors** | **40,000** |
| **Unsecured Creditors** | **11,00,000** |
| **Partly Secured Creditors (Assets realized ₹ 2,20,000)** | **2,75,000** |
| **Debenture holders having floating charge on all** | |
| **Assets of the company** | **5,00,000** |
| **Expenses of Liquidation** | **22,000** |

**A call of ₹ 3 per share on the partly paid equity shares was duly received except in case of one shareholder owning 1000 shares.**

**You are required to prepare the Liquidator's Statement of Account allowing for his remuneration @ 3% on all assets realized excluding call money received and 2% on the amount paid to unsecured creditors including preferential creditors.**

**Also calculate the percentage of amount paid to the unsecured creditors to the total unsecured creditors. [9]**

**Answer:**

Liquidators' Final Statement of Account

Dr. Cr.

| Receipts | Amount (₹) | Payments | Amount (₹) |
|---|---|---|---|
| Sundry Assets realized (given) | 14,00,000 | Liquidator's Remuneration | 65,980 |
| Calls on Contributories: Equity Shareholders [(20,000 – 1,000)×₹3 | 57,000 | Liquidation Expenses | 22,000 |
| | | Debenture holders | 5,00,000 |
| | | Preferential Creditors | 40,000 |
| | | Unsecured Creditors: Partly Secured Creditors to the extent Unsecured (₹2,75,000-₹2,20,000) | 55,000 |
| | | Fully Unsecured Creditors (balancing figure) | 7,74,020 |
| | 14,57,000 | | 14,57,000 |

**Percentage of amount paid to unsecured creditors to total unsecured creditors:**

$$\frac{₹55{,}000 + ₹7{,}74{,}020}{₹11{,}00{,}000(\text{Fully Unsecured}) + ₹55{,}000(\text{Partly Unsecured})} = 71.78\%.$$

Liquidator's Remuneration

| Particulars | Computation | Amount (₹) |
|---|---|---|
| 3% on all assets realized excluding Call Money, but including Sale of Securities held by Partly Secured Creditors | 3%(₹14,00,000+₹2,20,000) | 48,600 |
| 2% on amount paid to Preferential Creditors | $2\% \times 40{,}000$ | 800 |
| Sub-Total of above (for considering balance Commission) | | 49,400 |
| 2% on amount paid to Other Unsecured Creditors (excluding Preferential Creditors) | As per Note =₹8,45,600 $\times \frac{2}{102}$ | 16,580 |
| Total Remuneration to Liquidators | | 65,980 |

**Note:**

Amount available for Unsecured Creditors & Liquidator's Remuneration = Gross Amount ₹14,57,000 less (Expenses ₹22,000 + Remuneration ₹49,400 (as per Sub-total above) + Debenture holders ₹5,00,000 + Preferential Creditors ₹40,000) = ₹8,45,600.

- ✓ Amount payable to partly Secured Creditors after setting off the assets realized, is considered as the unsecured amount, and hence considered for calculating total amount payable to unsecured creditors.
- ✓ Assets held by partly Secured Creditors are assumed to be realized by the liquidator himself, and hence taken into account for computing his remuneration.
- ✓ It is assumed that there is no List B Contributory available in respect of amount unrealized on call from one shareholder (₹ 3x 1,000).

**(b) Lessee Ltd., took a machine on lease form Lessor Ltd. The fair value being ₹ 7,00,000. The economic life of the machine as well as the lease time is 3 years. At the end of each year lessee Ltd., pays ₹ 3,00,000. The lessee has guaranteed a residual value of ₹ 22,000 on expiry of the lease to the lessor. However Lessor Ltd., estimate that the residual value of the machinery will be only 15000. The implicit rate of return is 15% p.a and the present value factor at 15% are 0.869, 0.756 and 0.657 at the end of 1st, 2nd and 3rd year respectively.**
**Calculate the value of machinery to be considered by lessee Ltd., and the finance charges in each year. [6]**

**Answer:**

Calculation of finance charges for each year

| Year | Finance charges (₹) | Payments (₹) | Reduction in o/s liability (₹) | Outstanding liability (₹) |
|---|---|---|---|---|
| 1st year beginning | - | - | - | 6,99,054 |
| 1st ending | 1,04,858 | 3,00,000 | 1,95,142 | 5,03,912 |
| 2 nd year ending | 75,587 | 3,00,000 | 2,24,413 | 2,79,499 |
| 3 rd year ending | 41,925 | 3,00,000 | 2,58,075 | 21,424 |

Present value of minimum lease payment

Annual lease × p.v. factor + present value of guaranteed residual value

₹ 3,00,000 × (0.869+0.756+0.657)+ ₹ 22,000 × 0.657

₹ 6,84,600 + ₹ 14,454 ⇒ ₹ 6,99,054

Value of machinery:

Fair value of machinery is ₹ 7,00,000; the N.P value of minimum lease payment is ₹ 6,99,054.
As the present value of the machine is less than the fair value of the machine. The machinery will be recovered at the value of ₹ 6,99,054.

## Section – C
## Answer any two Questions

**9. (a) State the advantages of continuous audit.**
**(b) How would you determine the materiality of an item, while conducting audit.**
**[7+8 = 15]**

**Answer:**

**(a) Advantages of continuous audit:**
Continuous audit may be defined as the examination and verification of a firm's financial transactions and their supporting documents, continuously throughout the year, at regular or irregular intervals. Its main advantages are as follows:

(i) Early location of errors and frauds: It helps in detecting errors and frauds immediately on their occurrence, and not at the year end when it would become difficult to install corrective control mechanisms.
(ii) Quick rectification: Rectification of errors at an early stage is possible.
(iii) Guidance: Continuous guidance to client.
(iv) Finalizations of accounts completion in time: Just at the end of the accounting period.
(v) Moral check: Make employees of the client alert and more efficient in conducting their work.
(vi) Improves statutory auditor's focus: It relieves statutory auditors of routine testing and allows them to focus efforts on more valuable activities.

**(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.

**10. (a) What is Secret Reserve? How it may be created? How it is verified by an auditor?**
**(b) What are the special considerations to be kept in the mind during vouching?**

**[8+7 = 15]**

**Answer:**

**(a) Secret Reserve:**

Any reserve not appearing on the Balance Sheet is called as a Secret Reserve. The existence of the reserve may be inferred from an intelligent verification of the accounts by the auditor even though the amount cannot be ascertained. Generally such type of reserve appears in financial institutions and insurance companies. Secret reserve may be created by -

(i) Writing down the assets much below their cost
(ii) Providing excessive depreciation
(iii) Providing more reserve for doubtful debts etc.
(iv) Writing down the goodwill considerably
(v) Omitting certain assets from Balance Sheet
(vi) Charging capital expenditure to revenue account
(vii) Over valuing the liability
(viii) Showing contingent liabilities as real liabilities etc.,

According to the Provisions of Companies Act, 2013, creation of Secret Reserve is prohibited except in the case of banking, financial, insurance and electricity companies. To verify the secret reserve, if any, the auditor should keep in mind the following points:

(i) Carefully enquire into the necessity of creating such reserve.
(ii) Don't qualify audit report if it is found that the intention of the company is honest and the amount is reasonable.
(iii) May pass a remark in audit report that the assets are understated
(iv) Discuss the fact, if found, that the director's intention behind creating secret reserve was not honest and only to facilitate improper dealing in shares.

**(b) Special considerations during Vouching**:

(A) It is important to note that in vouching of payments, the auditor does not merely seek proof that money has been paid away, but keeps into consideration the following relevant points:
  (1) Checking the relevant documentary evidence: It helps in assuring the genuineness of the transaction and accuracy in its recording.
  (2) Checking the authority on the basis of which the entry has been made: It helps in assuring that the transaction has actually occurred.
  (3) Confirming that the amount mentioned in the voucher has been posted to the appropriate account: It helps in assuring the proper classification according to accounting policies and practices.
  (4) Checking that complete disclosure regarding the nature of the transaction is made.

(B) Thus, the general principles of vouching as well as auditing can be listed as under:
  (1) Genuineness
  (2) Accuracy
  (3) Authenticity
  (4) Authorization
  (5) Classification
  (6) Disclosure

**11. (a) Differentiate between Accounting and auditing.**
**(b) State the advantages of conducting Audit of Sole proprietors. [10+5 = 15]**

**Answer:**

**(a) Difference between Accounting and Auditing:**

| | **Accounting** | **Auditing** |
|---|---|---|
| **(i)** | It is the collection, classification and summarization of data for preparation of books of accounts, and to make financial statements. | Auditing is an analytical and critical examination of books of accounts, financial records and the financial statements prepared thereon. |
| **(ii)** | It is the recording of transactions at the | It is the post examination of recorded |

| | | |
|---|---|---|
| | time of occurrence. | transactions. |
| **(iii)** | It measures the business events in monetary terms, records them, and communicates the financial results through Financial Statements. | Auditing reviews financial records to form an opinion on the authenticity of Financial Statements. |
| **(iv)** | The primary responsibility is of the management towards the shareholders/ owners, to maintain the Financial records in such a manner that Financial Statements can be prepared from the records. | The auditor is an independent person appointed by the business entity to review the Financial Statements and to give his opinion thereon. |
| **(v)** | An accountant is not expected to review/ report on the Financial Statement but to report the compilation of records to the management. | An auditor is required to submit a report with his opinion on 'true and fair' assertions made in the Financial Statements to the owners. |
| **(vi)** | An accountant works for/ under the management. | The auditor is an independent person answerable/liable to the owners/ shareholders and not just to the management. |
| **(vii)** | No such liability | In certain circumstances, the auditor could be held liable to third parties also. |
| **(viii)** | Maintenance of accounts may not be mandatory for small individuals or partnership firms, e. g. under section 44AA of the Income Tax Act, but could be mandatory under other laws, e. g. for companies under the Companies Act. | Audit could be exempt for various individuals or small partnerships, e. g. under section 44AB of the Income tax Act, and even in case where maintaining books of accounts is a statutory requirement under section 44AA, but may be mandatory under other laws e. g. for Companies under the Companies Act. |
| **(ix)** | Accounting is done as per the principles set by Indian Accounting standards | Auditing is done as per the principal set in standards an auditing. |

**(b) ADVANTAGES OF AUDITING FOR SOLE PROPRIETORS**

(i) It evaluates the internal control system and strengthens it by removing weaknesses, if any.
(ii) It increases the reliability and authenticity of Financial Statements.
(iii) It helps in timely finalization of Annual Financial Statements and tax assessments.
(iv) It keeps a moral check on the working of employees.
(v) It helps them in obtaining funds easily from financial institutions, based on more reliable Financial Statements available to the banks and financial institutions.
(vi) It helps in settling:
→ Trade disputes
→ Labour disputes
→ Insurance claims