Paper 12 – Company Accounts & Audit

Whenever necessary suitable assumptions may be made and disclosed by way of note.
Working Notes should form part of the answers

Section A

(1) Answer the following (compulsory) [2x2=4]

(i) What do you mean by possible obligation under AS - 29? [2]

Answer:

An obligation is a possible obligation if based on the evidence available, its existence at the balance sheet date is considered not probable.

It must be noted that for contingent liability, the existence of possible obligation should be 'Not Probable' whereas for 'Provisions' it should be 'Probable'.

(ii) Explain the disclosure requirements under AS 11. [2]

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.

(2) Answer any two Questions [2x8=16]

(a) ABC Co. Ltd. supplied the following information. You are required to compute the basic earning per share:

(Accounting year 1-4-2009 - 31-3-2010)

Net Profit	**: Year 2009-10: ₹ 20,00,000**
	: Year 2010-11: ₹ 30,00,000
No. of shares outstanding prior to right Issue	**: 10,00,000 shares.**
Right Issue	**: One new share for each four outstanding ie., 2,50,000 shares. Right Issue price - ₹ 20 Last date of exercise rights - 30-6-2010**

Fair rate of one Equity share immediately prior to exercise right on 30-6-2010: ₹ 25. [8]

Solution:

Computation of Basic Earning per Share (EPS)

For 2009-10: 20,00,000/10,00,000 = ₹ 2

For calculating the EPS for 2010-11, right factor is to be calculated.

$$\textbf{Right factor} = \frac{\text{Fair value per share immediately prior to right issue}}{\text{Theoretical Ex-right fair value per share}}$$

Theoretical ex-right fair value per share

$$= \frac{\text{Aggregate fair value per share immediately prior to the exercise of right + Proceeds from right issue}}{\text{Number of shares outstanding after the right issue}}$$

= (10,00,000 X 25 + 2,50,000 X 20)/12,50,000 = 24

Right factor = 25/24 = 1.04

Basic EPS for 2010-11 = 30,00,000/{(10,00,000 X 1.04 X 3/12)+12,50,000 X 9/12}
= ₹2.50 per share

Adjusted EPS for 2009-10 = 20,00,000/(10,00,000 X 1.04)
= ₹ 1.92 per share

(b) X Ltd has got the license to manufacture particular medicines for 10 years at a licence fee of ₹500 lakhs, given below is the pattern of expected production and expected operating cash inflow.

Year	Production in bottles (In thousands)	Net operating cash flow (₹ in lakhs)
1	300	900
2	600	1800
3	650	2300
4	800	3200
5	800	3200
6	800	3200
7	800	3200
8	800	3200
9	800	3200
10	800	3200

Net operating cash flow has increased from third year because of better inventory management and handling method. Suggest the amortization method. [8]

Solution:

As per para 72 of Accounting Standard 26 on intangibles, the amortization method used should reflect the pattern in which economic benefits are consumed by the enterprise. If pattern cannot be determined reliably, then straight line method should be used.

In the instant case, the pattern of economic benefit in the form of net operating cash flow vis-a-vis production is determined reliably. Initially net operating cash flow per thousand bottles is ₹ 3 lakhs for first two years and ₹ 4 lakhs from fourth year onwards, the pattern is established and therefore the X Ltd should amortize the license fee of ₹ 500 lakhs as under:

Year	Net operating Cash inflow	Ratio	Amortize amount (₹ In lakhs)
1	900	0.03	15
2	1800	0.06	30
3	2300	0.08	40
4	3200	0.12	60
5	3200	0.12	60
6	3200	0.12	60
7	3200	0.12	60
8	3200	0.12	60
9	3200	0.12	60
10	3200	0.11	55
	27,400	1.00	500

(c)(i) What are the disclosures requirement relating to Contingent liabilities as per AS 29? [4]

Answer:

An enterprise should disclose for each class of contingent liability at the balance sheet date —

- A brief description of the nature of the contingent liability where practicable.
- An estimate of the amount as per measurement principles as prescribed for provision.
- Indications of the uncertainties relating to outflow.
- The possibility of any reimbursement.
- Where any of the information required as above is not disclosed because it is not practicable to do so, that fact should be stated.

An enterprise need not disclose any of the disclosure requirement if disclosure of any of this information is expected to prejudice seriously the case of the enterprise in disputes with other party.

(ii) Tip & Top Limited has set up its business in a designated backward area, which entitles the company to receive from the Government of India a subsidy of 20% of the cost of investment. Having fulfilled all the conditions under the scheme, the company on its investment of ₹ 100 crore in capital assets, received ₹ 20 crore from the Government in January 2010 (accounting period being 2009-2010). The company wants to treat this receipt as an item of revenue and thereby reduce the losses on profit and loss account for the year ended 31st March, 2010. Keeping in view the relevant Accounting Standard, discuss whether this action is justified or not. [4]

Solution:

The action of the Tip & Top Ltd. is not justified in view of Para 10 of AS-12. As per Para 10 of AS-12 "Accounting for Govt. Grants"

"Where the Govt. grants are of the nature of promoter contribution i.e. they are given with reference to the total investment in an undertaking or by way of promoters contribution towards its total capital outlay and no repayment is ordinarily expected in respect thereof the grants are treated as capital reserve, which can be neither distributed as dividend nor considered as deferred income."

Therefore it is inappropriate to recognize Government grants in the profit & loss statement for the year ended 31-3-2010. Since they are not earned but represent an incentive provided by Government without related cost.

Section B

3. Answer the following (compulsory) [4x2=8]

(i) Write short notes on reporting Cash Flows from Extra-ordinary items. [2]

Answer:

Cash Flows associated with extra-ordinary items should be classified as arising from Operating, Investing or Financing Activities as appropriate, and separately disclosed.

Separate disclosure will enable Users to understand their nature and effect on the present and future cash flows of the enterprise. These disclosures are in addition to the separate disclosures of the nature and amount of extraordinary items required by AS - 5.

(ii) What is Negative Goodwill in case of amalgamation in the nature of purchase? [2]

Answer:

If the consideration paid for amalgamation is less than the Net Assets of the Transferor Company, the difference is called Negative Goodwill. This should be recognised in the Transferee Company's Financial Statements as Capital Reserve.

(iii) Differentiate between Amalgamation and Absorption. [2]

Answer:

Amalgamation includes - (a) two or more Companies joining to form a New Company, and / or (b) absorption and blending of one by the other. Thus, Amalgamation includes Absorption also.

Absorption: When one or more Companies go into liquidation and some existing Company takes over its business, it is a case of absorption.

(iv) Explain the disclosure requirement of debit balance of Profit & Loss A/c. [2]

Answer:

Debit balance Statement of P&L shall be shown as a Negative figure under the head 'Surplus'. Similar, the balance of 'Reserves & Surplus', after adjusting Negative balance of Surplus, if any, shall be shown under the head 'Reserves & Surplus' even if the resulting figure is in the negative.

(4) Answer any two Questions [2x16=32]

(a) X Ltd and Y Ltd had the following Balance Sheets as on 31st March, 2013 - (in ₹)

Liabilities	X Ltd.	Y Ltd.	Assets	X Ltd.	Y Ltd.
Share Capital of ₹ 100 each	50,00,000	-	Fixed Assets	80,00,000	1,68,00,000
Share Capital of ₹ 10 each	-	80,00,000	Current Assets	69,00,000	1,60,00,000
Capital Reserve	10,00,000	-	Investments	20,00,000	-
General Reserve	36,00,000	1,00,00,000	Goodwill	2,00,000	-
Secured Loans	-	40,00,000			
Unsecured Loans	42,00,000	-			
Sundry Creditors	22,00,000	46,00,000			
Provision for Taxation	11,00,000	52,00,000			
Proposed Dividend	-	10,00,000			
Total	**1,71,00,00**	**3,28,00,000**	**Total**	**1,71,00,00**	**3,28,00,000**

X Ltd is amalgamated with Y Limited on the above date. For the purpose of amalgamation, the Goodwill of X Ltd is considered valueless. There are also arrears of depreciation of X Ltd amounting to ₹ 4,00,000.

The Shareholders in X Ltd are allotted, in full satisfaction of their claims, Shares in Y Limited in the same proportion as the respective Intrinsic Values of the Shares of the two Companies bear to one another. Pass Journal Entries in the books of both the Companies, to give effect to the above. [16]

Solution:

Since Fixed Assets are revalued by providing Arrears of Depreciation, the absorption is accounted under the Purchase Method, in the books of Purchasing Company.

1. Computation of Net Worth, Intrinsic Value and Purchase Consideration

Particulars	X Ltd	Y Ltd
Share Capital	50,00,000	80,00,000
Capital Reserve	10,00,000	-
General Reserve	36,00,000	1,00,00,000
Total of Capital and Reserves	96,00,000	1,80,00,000
Less: Goodwill considered valueless	(2,00,000)	-
Arrears of Depreciation to be provided for	(4,00,000)	-
Balance Tangible Net Worth	**90,00,000**	**1,80,00,000**
Number of Equity Shares (Share Capital ÷ ₹ 100, ₹ 10 respectively)	50,000	8,00,000

Intrinsic Value per Share	**₹ 180.00**	**₹ 22.50**

Exchange Ratio:

(a) Number of Shares to be issued by Y Ltd to X Ltd = $\frac{₹90,00,000}{₹22.50 \text{ per share}}$ = 4,00,000 Shares.

(b) Manner of Issue = 4,00,000 Shares of ₹ 10 Face value, issued at ₹ 12.50 Premium.

(c) Exchange Ratio = 4,00,000 Shares of Y Ltd for 50,000 Shares of X Ltd, i.e. 8 Shares of Y Ltd for every Share of X Ltd.

Note: Tangible Net Worth can also be computed as Net Tangible Assets **Less** External Liabilities, i.e. Net Assets Taken Over. However, in this sum, the **"Liability Route"** for computing the Intrinsic Value is considered.

2. Journal Entries in the books of X Ltd

S. NO.	Particulars	Dr.(₹)	Cr. (₹)
1.	Realisation A/c Dr.	1,71,00,000	
	To Fixed Assets A/c		80,00,000
	To Current Assets A/c		69,00,000
	To Investment A/c		20,00,000
	To Goodwill A/c		2,00,000
	(Being transfer of Sundry assets to Realisation A/c on sale of business)		
2.	Unsecured Loans A/c Dr.	42,00,000	
	Sundry Creditors A/c Dr.	22,00,000	
	Provision for Taxation A/c Dr.	11,00,000	
	To Realisation A/c		75,00,000
	(Being transfer of Sundry Liabilities to Realisation A/c, on sale of business)		
3.	Y Ltd A/c Dr.	90,00,000	
	To Realisation A/c		90,00,000
	(Being Purchase Consideration due under the agreement)		
4.	Shares in Y Ltd A/c Dr.	90,00,000	
	To Y Ltd A/c		90,00,000
	(Being Shares received against Purchase Consideration due)		
5.	General Reserve A/c Dr.	36,00,000	
	Capital Reserve A/c Dr.	10,00,000	
	To Sundry Shareholders A/c		46,00,000
	(Being transfer of General Reserve and Capital Reserve to Sundry Shareholders)		
6.	Sundry Shareholders A/c Dr.	6,00,000	
	To Realisation A/c		6,00,000
	(Being Loss on Realisation transferred, i.e. Net Effect of JE 1, 2 & 3)		
6.	Share Capital A/c Dr.	50,00,000	
	To Sundry Shareholders A/c		50,00,000
	(Being transfer of Share Capital to Sundry Shareholders' A/c)		

7.	Sundry Shareholders A/c Dr. To Shares in Y Ltd A/c (Being distribution of Shares in Y Ltd among the shareholders)	90,00,000	 90,00,000

3. Journal Entries in the books of Y Ltd

S. No.	Particulars	Dr.(₹)	Cr. (₹)
1.	Business Purchase A/c Dr. To Liquidator of X Ltd A/c (Being Purchase Consideration due as per agreement)	90,00,000	 90,00,000
2.	Fixed Assets A/c Dr. Current Assets A/c Dr. Investments A/c Dr. To Unsecured Loans A/c To Sundry Creditors A/c To Provision for Taxation A/c To Business Purchase A/c (Being assets and liabilities taken over from X Ltd as per agreement dated...)	76,00,000 69,00,000 20,00,000	 42,00,000 22,00,000 11,00,000 90,00,000
3.	Liquidator of X Ltd A/c Dr. To Equity Share Capital A/c To Securities Premium A/c (Being issue of 4,00,000 Shares of ₹ 10 each issued at Premium of ₹ 12.50 each, to the Liquidator of X Ltd in settlement of Purchase Consideration)	90,00,000	 40,00,000 50,00,000

4. Balance Sheet of Y Ltd as at 31st March, 2013 (after Absorption)

	Particulars as at 31st March ,	Note	This Year	Prev. Yr
I	**EQUITY AND LIABILITIES:**			
(1)	**Shareholders' Funds:**			
	(a) Share Capital	**1**	1,20,00,000	
	(b) Reserves and Surplus	**2**	1,60,00,000	
(2)	**Non-Current Liabilities:**			
	Long Term Borrowings	**3**	82,00,000	
(3)	**Current Liabilities:**			
	(a) Trade Payables Creditors (22,00,000 + 46,00,000)		68,00,000	
	(b) Short Term Provisions Provision for Taxation (11,00,000 + 52,00,000)		63,00,000	
	Total		**4,93,00,000**	
II	**ASSETS**			
(1)	**Non-Current Assets**			
	(a) Fixed Assets: Tangible Assets (76,00,000 + 1,68,00,000)		2,44,00,000	
	(b) Non - Current Investments		20,00,000	
(2)	**Current Assets** (69,00,000 + 1,60,00,000)		2,29,00,000	
	Total		**4,93,00,000**	

Note 1: Share Capital

Particulars	This Year	Prev. Yr
Authorised: ....Equity Shares of ₹ 10 each		
Issued, Subscribed & Paid up: 12,00,000 Equity Shares of ₹ 10 each (Of the above, 4,00,000 Shares were issued for non-cash consideration)	1,20,00,000	
Total	**1,20,00,000**	

Note 2: Reserves and Surplus

Particulars	This Year	Prev. Yr
(a) Securities Premium Reserve	50,00,000	
(b) Other Reserve	1,00,00,000	
(c) Surplus (P & L A/c with Proposed Dividend added back)	10,00,000	
Total	**1,60,00,000**	

Note: The amount, % and per Share Dividend shall be disclosed as a Footnote to the Balance Sheet.

Note 3: Long Term Borrowings

Particulars	This Year	Prev. Yr
(a) Secured Loans	40,00,000	
(b) Unsecured Loans	42,00,000	
Total	**82,00,000**	

(b)(i) Awada Limited issued 10 % Debentures at par for ₹ 16 Lakhs on 01.01.2011. Interest was payable half yearly on 30th June and 31st December every year. Under the terms of the Trust Deed, the Debentures are redeemable at par (three years after issue) by the Company purchasing them in the Open Market and cancelling, them with a minimum redemption of ₹ 1,60,000 every year.

In case, there is a shortfall in redemption by the Company by Open Market Operations, the shortfall would be made good by the Company by payment on the last day of the accounting year to the Trustees, who would then draw lots and redeem the balance Debentures.

The Company purchased its Own Debentures for cancellation as under: -

- **30.09.2011 ₹ 2,00,000 at ₹ 98 cum-interest.**
- **31.05.2012 ₹ 1,20,000 at ₹ 95 ex-interest.**
- **31.07.2013 ₹ 1,80,000 at ₹ 96 cum-interest.**

The Company carried out its obligations under the Trust Deed. Prepare the following Ledger Accounts in the books of the Company, for Calendar Years 2011, 2012 and 2013 - (a) Debentures A/c, (b) Debenture Redemption A/c, and (c) Debenture Interest A/c. Ignore Taxation. [8]

Solution:

1. 10% Debentures A/c

Date	Particulars	₹	Date	Particulars	₹
30.09.2011	To Debentures Redemption A/c (Purchase for Cancellation)	2,00,000	01.01.2011	By balance b/d	16,00,000
31.12.2011	To balance c/d	14,00,000			
	Total	**16,00,000**		**Total**	**16,00,000**
31.05.2012	To Debenture Redemption A/c (Purchase for Cancellation)	1,20,000	01.01.2012	By balance b/d	14,00,000

31.12.2012	To Debenture Redemption A/c (Shortfall made over to Trustees)	40,000			
31.12.2012	To balance c/d	12,40,000			
	Total	**14,00,000**		**Total**	**14,00,000**
31.07.2013	To Debenture Redemption A/c (Purchase for Cancellation)	1,80,000	01.01.2013	By balance b/d	12,40,000
31.12.2013	To balance c/d	10,60,000			
	Total	**12,40,000**		**Total**	**12,40,000**

2. Computation of interest paid on Debentures at 10% p.a.

Date	Amount of Debentures (in ₹) (A)	Period (in Months) (B)	Amount of Interest (in ₹) (C)= [(A) x (B)] / 12
(a) 30.06.2011	16,00,000	**6**	80,000
(b) 30.09.2011	2,00,000	**3**	5,000
(c) 31.12.2011	14,00,000	**6**	70,000
(d) 31.05.2012	1,20,000	**5**	5,000
(e) 30.06.2012	12,80,000	**6**	64,000
(f) 31.12.2012	12,80,000	**6**	64,000
(g) 30.06.2013	12,40,000	**6**	62,000
(h) 31.07.2013	1,80,000	**1**	1,500
(i) 31.12.2013	10,60,000	**6**	53,000

Note: Refer Debentures A/c in WN 1 for the amount outstanding as on the respective date.

3. Debenture Interest A/c

Date	Particulars	₹	Date	Particulars	₹
30.06.2011	To Bank	80,000	31.12.2011	By Profit and Loss A/c (transfer)	1,55,000
30.09.2011	To Bank **(Note)**	5,000			
31.12.2011	To Bank	70,000			
	Total	**1,55,000**		**Total**	**1,55,000**
31.05.2012	To Bank **(Note)**	5,000	31.12.2012	By Profit and Loss A/c (transfer)	1,33,000
30.06.2012	To Bank	64,000			
31.12.2012	To Bank	64,000			
	Total	**1,33,000**		**Total**	**1,33,000**
30.06.2013	To Bank	62,000	31.12.2013	By Profit and Loss A/c (transfer)	1,16,500
31.07.2013	To Bank **(Note)**	1,500			
31.12.2013	To Bank	53,000			
	Total	**1,16,500**		**Total**	**1,16,500**

Note: Interest paid on Debentures redeemed during the year can be shown through Debenture Redemption A/c also.

Debenture Redemption A/c

Date	Particulars	₹	Date	Particulars	₹
30.09.2011	To Bank (1,96,000 - 5,000) **[WN 2(b)]**	1,91,000	30.09.2011	By 10% Debentures A/c	2,00,000
30.09.2011	To P&L A/c (Profit on Cancellation)	9,000			
	Total	**2,00,000**		**Total**	**2,00,000**

31.05.2012 31.05.2012 31.12.2012	To Bank (1,200 x 95) To P&L A/c (1,20,000 – 1,14,000) To Bank - amount made over to Trustees - (assumed redeemed at par)	1,14,000 6,000 40,000	31.05.2012 31.12.2012	By 10% Debentures A/c By 10% Debentures A/c	1,20,000 40,000
	Total	**1,60,000**		**Total**	**1,60,000**
31.07.2013 31.07.2013	To Bank [(1,800 x 96) – 1,500] To P&L A/c(Profit on Cancellation)[WN 2(h)]	1,71,300 8,700	31.07.2013	By 10% Debentures A/c	1,80,000
	Total	**1,80,000**		**Total**	**1,80,000**

(ii) Excess Ltd grants 100 Stock Options to each of its 1,000 Employees on 01.04.2009 for ₹ 20, depending upon the Employees at the time of vesting of options. The Market Price of the Share is ₹ 50. These Options will vest at the end of the Year 1 if the earning of Excess Ltd increases 16% or it will vest at the end of the third year if the average earning of 3 years will increase by 10%. 5,000 Unvested Options lapsed on 31.03.2010. 4,000 Unvested Options lapsed on 31.03.2011 and finally 3,500 Unvested Options lapsed on 31.03.2012.

The earning in % of Excess Ltd are - for the Year ended (a) 31.03.2010 -14%, (b) 31.03.2011 -14%, (c) 31.03.2012 - 7%

850 employees exercised their vested options within a year and remaining options were unexercised at the end of the contractual life. Pass Journal Entries for the above. [8]

Solution:

Value of Option: Intrinsic Value = MPS on Grant Date **Less** Exercise Price = ₹ 50 - ₹ 20 = ₹ 30.

Since Average Earning increases by more than 10%, [(14 + 14 + 7) ÷ 3], the Options will vest at the end of Year 3. This can be exercised within one year from that date, i.e. before the end of Year 4. It is assumed that the 850 Employees exercised their Vested Options on the last available date, i.e. end of Year 4.

Particulars	Year 1 (31.03.2010)	Year 2 (31.03.2011)	Year 3 (31.03.2012)
Length of Expected Vesting Period (at end of year)	2nd year	3rd year	3rd year
Number of Options expected to vest	1,00,000 - 5,000 = 95,000 Options	95,000 - 4,000 = 91,000 Options	91,000 - 3,500 = 87,500 Options
Total Compensation Expense at ₹ 30 per Option **(Note)**	₹ 28,50,000	₹ 27,30,000	₹26,25,000
Compensation Expense for the year	28,50,000 x ½ = ₹ 14,25,000	28,50,000 x 2/3 = ₹ 18,20,000	₹ 26,25,000
Compensation Expense	Nil	₹ 14,25,000	₹ 18,20,000

recognized previously			
Compensation Expense to be recognized for the year	₹ 14,25,000	₹ 3,95,000	₹ 8,05,000

2. Journal Entries

Date	Particulars	Dr. (₹)	Cr. (₹)
Year 1			
31.03.2010 (yr-end)	Employee Compensation Expense A/c Dr. To Employee Stock Options Outstanding A/c (Being Compensation Expense recognized under ESOP, i.e.100 Options granted to 1,000 employees at a Discount of ₹ 30 each, amortized on Straight Line basis over vesting years) **(Refer WN)**	14,25,000	 14,25,000
31.03.2010 (yr-end)	Profit and Loss A/c Dr. To Employee Compensation Expense A/c (Being Employees Compensation Expense of the year transferred to P&L A/c)	14,25,000	 14,25,000
Year 2			
31.03.2011 (yr-end)	Employee Compensation Expense A/c Dr. To Employee Stock Options Outstanding A/c (Being Employee Compensation Expense for the year, recognized in respect of the Employee Stock Option Plan) **(Refer WN)**	3,95,000	 3,95,000
31.03.2011 (yr-end)	Profit and Loss A/c Dr. To Employee Compensation Expense A/c (Being Employees Compensation Expense of the year transferred to P&L A/c)	3,95,000	 3,95,000
Year 3			
31.03.2012 (yr-end)	Employee Compensation Expense A/c Dr. To Employee Stock Options Outstanding A/c (Being Employee Compensation Expense for the year, recognized in respect of the Employee Stock Option Plan) **(Refer WN)**	8,05,000	 8,05,000
31.03.2012 (yr-end)	Profit and Loss A/c Dr. To Employee Compensation Expense A/c (Being Employees Compensation Expense of the year transferred to P&L A/c)	8,05,000	 8,05,000
Year 4			
31.03.2013 (Date of exercise of Option)	Bank A/c (85,000 Options X 20) Dr. Employee Stock Options Outstanding A/c Dr. (85,000 Options x ₹ 30) To Equity Share Capital A/c (85,000 Options x ₹ 10) To Securities Premium A/c (85,000 Options x ₹ 40) (Being 85,000 Employee Stock Options exercised at a Price of ₹ 50 each)	17,00,000 25,50,000	 8,50,000 34,00,000
31.03.2013	Employee Stock Option Outstanding A/c Dr.	75,000	

(yr-end)	(2,500 Options x ₹ 30) To General Reserve A/c (Being ESOS Outstanding A/c on the lapse of 2,500 Options at the end of exercise of Option period transferred to General Reserve A/c)		75,000

(c) On 1st April, 2013, Surya Ltd was incorporated with an Authorised Capital of ₹ 800 Crores. It issued its Equity Capital of ₹ 50 Crores which was paid for in full. On that day, it purchased the running business of Mitra Ltd for ₹ 200 Crores, and allotted at par Equity Capital of ₹ 200 Crores in discharge of the consideration.

The Net Assets taken over from Mitra Ltd were valued as follows: (a) Fixed Assets - ₹ 150 Crores. (b) Inventory - ₹ 10 Crores, (c) Customers Dues - ₹ 70 Crores, and (d) Creditors - ₹ 30 Crores.

Mitra Ltd carried on business by adopting 1st April, 2013 to 31st March, 2014 as the accounting year, and the following information is furnished to you:

(i) Summary of Cash / Bank Transactions (for year ended 31st March, 2014)

Receipts	₹ Crores	Payments	₹ Crores
Equity Capital raised:		Payments to Suppliers	2,000
- Promoters (as shown above)	50	Payments to Employees	700
- Others	250	Payments to Expenses	500
Collections from Customers	4,000	Investments in Upkar Ltd	100
Sale Proceeds of Fixed Assets	20	Payments to Suppliers of Fixed	
(Cost₹ 18 Crores)		Assets:	
		- Instalment due	600
		- Interest	50
		Tax Payment	270
		Dividend	50
		Closing Cash / Bank Balance	50
Total	4,320	Total	4,320

(ii) On 31st March, 2014 (i.e. at the end of the financial year), Surya Ltd's Assets and Liabilities were:

Particulars	₹ Crores
Inventory at Cost	15
Customers' Dues	400
Prepaid Expenses	10
Advances to Suppliers	40
Amounts due to Suppliers of Goods	260
Amounts due to Suppliers of Fixed Assets	750
Outstanding Expenses	30

(iii) Depreciation for the relevant accounting year were as under - (1) Under the Companies Act, 1956 - ₹ 180 Crores, (2) Under the Income Tax Act, 1961 - ₹ 200 Crores

(iv) Provide for Income Tax at 30% of "Total Income". There are no disallowables for the purpose of determining Total Income under Income Tax Act.

From the above data, Surya Ltd asks you to prepare - (1) Revenue Statement for the year ended 31st October, and (2) Balance Sheet as on that date. (Ignore Surcharge) [16]

Solution:

1. Value of Net Assets Taken Over

Particulars	₹ Crores
Fixed Assets	150
Inventory	10
Customers Dues	70
Total Assets	230
Less: Creditors	(30)
Net Assets = Purchase Consideration (There is no Goodwill or Capital Reserve)	200

Discharge of Purchase consideration: 20 Crores Equity Shares of ₹ 10 each totaling ₹ 200 Crores.

2. Customers Account (to find out Sales)

Particulars	₹ Crores	Particulars	₹ Crores
To Business Purchase A/c	70	By Bank A/c	4,000
To Sales (balancing figure)	4,330	By balance c/d - given	400
Total	**4,400**	Total	**4,400**

3. Suppliers (Goods) Account (to find out Purchases)

Particulars	₹ Crores	Particulars	₹ Crores
To Bank A/c	2,000	By Business Purchase A/c	30
To balance c/d - given	260	By Purchases A/c - (balancing figure)	2,190
		By balance c/d - Advance to Suppliers (given)	40
Total	**2,260**	**Total**	**2,260**

4. Suppliers (Fixed Assets) A/c (to find out Fixed Assets purchased)

Particulars	₹ Crores	Particulars	₹ Crores
To Bank A/c (including Interest)	650	By Fixed Assets A/c (Balancing figure)	**1,350**
To balance c/d - Due (given)	750	By Interest A/c - given	50
Total	**1,400**	**Total**	**1,400**

5. Fixed Assets Account (to find out Closing Balance)

Particulars	₹ Crores	Particulars	₹ Crores
To Business Purchase A/c	150	By Bank A/c - Sale of Fixed Assets	**20**
To Profit & Loss A/c (Sale 20 - Cost 18)	2	By balance c/d (balancing figure)	**1,482**
To Suppliers A/c **(WN 4)**	1,350		
Total	**1,502**	**Total**	**1,502**

6. Outstanding Expenses Account (to find out Expenses for the year)

Particulars	₹ Crores	Particulars	₹ Crores
To Bank A/c	500	By Profit and Loss A/c (balancing figure)	**520**
To balance c/d (Outstanding Expenses)	30	By balance c/d (Prepaid Expenses	10

		at year-end)	
Total	**530**	**Total**	**530**

8. Balance Sheet of Surya Ltd as at 31st March, 2014 (in ₹ Crores)

	Particulars as at 31st March	Note	This Year	Prev. Yr
I	**EQUITY AND LIABILITIES:**			
(1)	**Shareholders' Funds:**			
	(a) Share Capital	**1**	500	
	(b) Reserves and Surplus - Surplus (P&L ₹ 488 **Less** Equity Dividend paid ₹ 50)		438	
(2)	**Non-Current Liabilities:**			
	(a) Long Term Borrowings - Unsecured Loans for Fixed Assets		750	
	(b) Deferred tax liabilities (Net)		6	
(3)	**Current Liabilities:**			
	(a) Trade Payables	**2**	290	
	(b) Short Term Provisions - Provision for Tax		203	
	Total		**2,187**	
II	**ASSETS**			
(1)	**Non-Current Assets**			
	(a) Fixed Assets:			
	Tangible Assets (Gross Block 1,482 **Less** Deprn 180)		1,302	
	(b) Non-Current Investments (in Upkar Ltd at Cost)		100	
(2)	**Current Assets:**			
	(a) Inventories		15	
	(b) Trade Receivables - Sundry Debtors		400	
	(c) Cash and Cash Equivalents - Balances with Banks and Cash on Hand		50	
	(d) Short Term Loans and Advances	**3**	310	
	(a) Other Current Assets - Prepaid Expenses		10	
	Total		**2,187**	

7. Profit and Loss Account of Surya Ltd for the year ending 31st March, 2014 (in ₹ Crores)

	Particulars	Note	This Yr	Prev. Yr
I	Revenue from Operations (WN 2)		4,330	
II	Other Income		-	
III	**Total Revenue (I + II)**		**4,330**	

IV	**Expenses:** (a) Cost of Materials Consumed (b) Purchases of Stock-in-Trade (c) Changes in Inventories of Finished Goods/ Work-in-Progress & Stock-In-Trade (d) Employee Benefits Expense (e) Finance Costs - Interest (f) Depreciation & Amortization Expense (g) Other Expenses (WN 6)	**4**	2,185 - - 700 50 180 520	
	Total Expenses		**3,635**	
V	Profit Before Exceptional & Extraordinary Items and Tax (III - IV)		**695**	
VI	Exceptional Items - Profit on Sale of Fixed Assets		**2**	
VII	Profit Before Extraordinary Items and Tax (V + VI)		**697**	
VIII	Extraordinary Items		Nil	
IX	Profit Before Tax (VII - VIII)		**697**	
X	Tax Expense: (a) Current Tax - Provision for Tax (b) Deferred Tax (200 – 180) × 30%	**5**	203 6	
XI	Profit / (Loss) for the period from Continuing Operations (IX - X)		**488**	
XII	Profit / (Loss) from Discontinuing Operations		**-**	
XIII	Tax Expense from Discontinuing Operations		**-**	
XIV	Profit / (Loss) from Discontinuing Operations (After Tax) (XII - XIII)		**-**	
XV	Profit / (Loss) for the period (XI + XIV)		**488**	
XVI	Earnings per Equity Share (a) Basic (₹ 488 Crores ÷50 Crore Equity Shares) (b) Diluted		**₹9.76** **₹9.76**	

Note 1: Share Capital

Particulars	This Year	Prev. Yr
Authorised: .... Equity Shares of... each	800	
Issued, Subscribed & Paid up: 50 Crore Equity Shares of ₹ 10 each (Of the above, 20 Crore Shares issued for non-cash consideration on Business Takeover)	500	
Total	**500**	

Note 2: Trade Payables

Particulars	This Year	Prev. Yr
Creditors for Goods	260	
Outstanding Expenses	30	
Total	**290**	

Note 3: Short Term Loans & Advances

Particulars	This Year	Prev. Yr
Loans & Advances (Suppliers)	40	
Advance Tax	270	
Total	**310**	

Note: It is assumed that Provision for Taxation and Advance Tax are not netted off at the end of this year.

Note 4: Cost of Materials Consumed

Particulars	This Year	Prev. Yr
Raw Materials = Opening Stock 10 **Add** Purchases (WN 3) 2,190 **less** Closing Stock (15)	**2,185**	

Note 5: Current Tax Expense

	Particulars	₹ Crores
	Profit before Depreciation **(WN 8)**	875
Less:	Depreciation under Income Tax Rules	(200)
	Total Income under Income Tax Act	675
	Tax due thereon at 30% (Rounded off)	**203**

Note: Since Sale Proceeds of Fixed Assets are reduced from the appropriate "Block of Assets" under Income Tax Rules, and also since the amount of Depreciation under Income Tax Rules, is given, no adjustment for Profit on Sale of Fixed Assets ₹ 2 Crores has been made for Income Tax Purposes.

Section C

(5) Answer the following (compulsory) [4x2=8]

(i) Explain the concept of Continuous Audit. [2]

Answer:

Continuous audit involves the detailed examination of all the transactions by the auditor continuously throughout the year or at regular intervals, say fortnightly or monthly. A continuous audit is one which is commenced and carried on before the close of the financial year to which it relates. It involves the constant engagement of auditor's staff at the client office throughout the period under review. Continuous audit is suitable in cases where the final accounts are desired to be presented soon after the close of the financial year or there is great volume of transactions or the system of internal check is weak.

(ii) How do you verify "Goods on Approval"? [2]

Answer:

The auditor should ensure that any goods sent to customers on approval which were unsold at the close of the year have not been treated as sold and are shown in the account as Stock on Approval and are valued at lower of the cost or market value. In case they are reported to have suffered any damage, a provision for the same should be made.

(iii) What do you understand by Piecemeal Opinion? [2]

Answer:

The Auditor, may in some cases, find that the Financial Statements he has examined present only a partial true and fair view. In such cases, he may report that he is unable to express an opinion, limited to certain items in the statement, with which he is satisfied. Such a situation would warrant a Piecemeal Opinion. As the name suggests, the Auditor gives a divided opinion on matters with which he is satisfied and with which he is not. The Auditor should state the reasons for having given a Piecemeal Opinion.

(iv) Bharat is the Statutory Auditor of Kapil Ltd. In accordance with the terms of appointment, he recovers his fees on a progressive basis, as and when the work is done, without waiting for completion of the whole job. Will the question of indebtedness u/s. 226(3) arise at any stage? [2]

Answer:

Where in accordance with terms of engagement, an Auditor recovers his fees on a progressive basis, he cannot be said to be indebted to the Company at any stage. So, Bharat is not disqualified u/s 226(3)(d).

(6) Answer any one Question [1x8=8]

(a) What are the scope and objectives of Internal Audit? [8]

Answer:

Scope and Objectives of Internal Audit

As per SA 400, Internal Control System refers to all the policies and procedures adopted by the management of the entity to assist in achieving management's objective ensuring the orderly and efficient conducting the business, the accuracy and completeness of accounting records, the timely preparation of financial information, safeguarding of assets of enterprise and defection of fraud and error in a timely manner. The internal audit function constitutes a separate component of internal control with the objective of determining whether other internal controls are well designed and properly evaluated.

The scope and objectives of internal audit vary widely and are dependent upon the size and structure of the entity and the management's requirements. The internal audit normally operates in one or more of the following areas:

(i) **Review of accounting system and related internal controls.—**Although the establishment of an adequate accounting system and related internal controls is the responsibility of the management, the internal audit function is entrusted with the responsibility of their review to ensure that they are operating effectively and recommend any improvements thereto;

(ii) **Examination for management of financial and operating information.—**It includes the review of the means used to identify, measure, classify and report such information and specific inquiry into individual items including tests of transactions;

(iii) **Examination of the economy, efficiency and effectiveness of operations including the no financial controls of an organisation.—**This will help the external auditor when it has an important bearing on the reliability of the financial records;

(iv) Physical examination and verification.—It includes the examination and verification of physical existence and condition of the tangible assets of the entity.

The objects of internal audit can be stated as follows:

(i) Verification of the accuracy and authenticity of the financial, accounting and statistical records.

(ii) Ascertaining that accepted accounting policies and practices have been followed while preparing the financial accounts.

(iii) The assets are purchased or disposed under proper authorisation. Also ensuring that the access to assets is restricted to the authorised persons at the authorised times.

(iv) Confirming that the liabilities are incurred for the legitimate activities of the organisation.

(v) The internal check system operating in the organisation is sound and economical.

(vi) Frauds and errors are prevented and detected.

(vii) Reviewing the overall operations of internal control system and if deviations or weaknesses are noted, the same are communicated to the appropriate authorities on timely basis. This will help in instituting corrective actions.

(b)(i) What are the procedures to be followed by the auditor of the company to verify the contingent liabilities ? [4]

Answer:

Contingent liabilities refer to obligations relating to the past transactions or other events or conditions that may arise in consequence of one or more future events which are presently deemed possible but not probable. The uncertainty as to whether there will be any legal obligation differentiates a contingent liabilities from a liability that has crystallised.

The following general procedures may be useful in verifying contingent liabilities:

(i) review of minutes of the meeting of BOD/committees of BOD/other similar body;
(ii) review of contracts, agreements and the arrangements;
(iii) review of list of pending legal cases etc;
(iv) review of terms and conditions of grants and subsidies availed under various schemes;
(v) review of records relating to contingent liability;
(vi) management representations;
(vii) ensure that contingent liability do not include any item which require an adjustment of relevant assets or liabilities.

(ii) What are the methods of statistical sampling? [4]

Answer:

Methods of statistical sampling

There are two main methods for determining the size of sample viz. Judgmental sampling and Statistical sampling. Each one of these methods is discussed below:

Judgmental Sampling.—In this method, the sample size is determined on the basis of the personal experience and the knowledge of the auditor. It is one of the simple methods of sampling. It may be noted that this method, though simple in its applicability, is neither scientific nor objective. The risk of personal bias in selection of sample is always present. Thus, an element of subjectivity does prevail in this method.

Statistical Sampling.—This method is more scientific in its approach than the method of judgmental sampling. It involves application of mathematical techniques like theory of probability, use of random number tables etc. But it may also be noted that the auditor need not require having an in depth understanding of the statistical techniques because published statistical tables are available which indicate the sample size based on predetermined criteria.

(7) Answer any two Questions [2x12=24]

(a) What are the principles of an effective internal check system? [12]

Answer:

The following are the main principles of an effective internal check system:

(i) Clearly and precisely define the authorities, duties and responsibilities of the staff.

(ii) The work should be divided amongst the staff depending on their capacity as well as capability. Ensure that there is no overlapping or duplication of work at any level.

(iii) Division of work should be such that no single individual is allowed to perform any work single handed from beginning to end.

(iv) Regular rotation of employees should be followed. This would ensure not only the prevention of errors and frauds but also broaden their work experience. The enterprise can also consider granting leaves to the employees at regular intervals. This would ensure that the fraud or error committed by any one could be detected by his substitute during the leave period.

(v) Instruction manuals should be clear. The employees should be given clear cut instructions so that the work can be performed in a timely and efficient manner.

(vi) There should be self balancing system of accounting providing for control of subsidiary ledgers through an account in the general ledger.

(vii) Perpetual system of maintaining inventory should be implemented so as to ensure continuous accountability.

(viii) Use of mechanical and electronic equipment such as cash registers, calculators, computers etc. should be encouraged.

(ix) Vouchers should be filed systematically. These should be dated, serially numbered and signed by the appropriate official.

(x) Cash receipts should be deposited into the bank on daily basis.

(xi) Correspondence with debtors and creditors should be under the charge of a responsible person.

(xii) Verification and valuation of stock, sales, payment of wages, fixed assets etc. should be under strict vigilance and control.

Last but not the least, the system of internal check operating in the enterprise should be evaluated and reviewed on periodic basis. This will ensure the effectiveness of internal check system on a continuous basis.

(b)(i) What are the advantages of an Audit Programme ? [6]

Answer:

The main advantages of an audit programme are as follows:

(i) It serves as a ready check list of audit procedures to be performed.

(ii) The audit work can be properly allocated to the audit assistants or the article clerks.

(iii) The auditor may easily know the extent of work done at any point of time. Thus, the progress of work done can be under the supervision and control of the auditor.

(iv) Audit programme would not only be useful for the audit assistants in carrying the audit work but for the principal too as he would be in a position to account for the individual responsibilities.

(v) A uniformity of the work can be attained as the same programme would be followed from time to time.

(vi) It is a useful basis for planning the programme for the following year.

(vii) It may be used as evidence by the auditor in the event when any charge is brought against him. He can prove that there has no negligence on his part and he exercised reasonable care and skill while performing the task.

(ii) What are the factors to be considered for incorporating quality control in audit work? [6]

Answer:

The audit firm should implement quality control policies to ensure all audits are conducted in accordance with Auditing and Assurance Standards. The following essential factors should be considered for incorporating quality control in audit work -

(a) **Professional Requirements,—**Adherence to basic principles such as independence, integrity, objectivity, confidentiality, etc.

(b) **Skills and competence.—**Audit personnel should have required degree of skill and competence.

(c) **Assignment.—**Audit work should be assigned only to competent personnel.

(d) **Delegation.—**There is to be sufficient direction, supervision and review of work at all levels.

(e) **Consultation.—**Whenever necessary, consultancy within and outside the firm with experts.

(f) **Acceptance and Retention of clients.—**Evaluation of prospective client and review of existing client should be done on an ongoing basis.

(g) **Monitoring.—**Continued adequacy and operational effectiveness of quality control policies and procedures should be monitored.

The firm's quality control policies and procedures should be effectively communicated to its personnel.

(c)(i) On what Companies the Companies (Auditor's Report) Order, 2003 is applicable and what Companies are not covered by it? [4]

Answer:

Applicability: CARO 2003 applies to all Companies including a Foreign Company as defined u/s 591 of the Companies Act, 1956.

Exceptions: CARO does not apply to the following classes of Companies -

(1) Banking Company as defined u/s 5(c) of the Banking Regulation Act, 1949,

(2) Insurance Company as defined u/s 2(21) of the Companies Act, 1956,

(3) Company licensed to operate u/s 25 of the Companies Act, 1956 and

(4) Private Limited Companies subject to the following conditions -

- Aggregate of Paid Up Capital and Reserves should not exceed **₹50 Lakhs.**
- Loan outstanding from any Bank or Financial Institution should not exceed **₹25 Lakhs.**
- The Turnover should not exceed **₹5 Crores.**

"Chit Fund", "Nidhi" or "Mutual Benefit" Company [2(b)]:

1. These Companies - (i) manage, (ii) conduct, or (iii) supervise as a foreman / agent, monetary transactions.
2. Such transactions or arrangement is based upon an agreement between the Company and a number of people called as Subscribers.
3. Each Subscriber shall subscribe a certain amount of money as installment for a definite period of time.
4. At the end of every instalment period, one subscriber shall be entitled to the prize amount. Such entitlement comes either - (i) by draw of lots, or (ii) by auction, or (iii) by tender, or (iv) in such other manner as may be provided for in the agreement.
5. The definition also includes Companies whose principal business is accepting Fixed Deposits from and also lending to its members.

(ii) Assets purchased under Hire-Purchase System were reflected at their full value and the outstanding instalments payable have been included under Sundry Creditors. How will you deal with the above situation? [4]

Answer:

Accounting Treatment: For assets acquired under HP System, the capital portion of the instalments paid up to date of Balance Sheet should be debited to the Asset Account, and the Interest included in each instalment and penal interest, if any, should be charged off to revenue.

Depreciation: Depreciation should be provided on the full cash purchase price of the asset. The net book value should be shown in the Balance Sheet.

Conclusion: The treatment given by the Company in the accounts is not correct and shall be rectified in the above manner.

(iii) Outline the scope of Auditors' Duties vis-a-vis Inventories. [4]

Answer:

In Re. Kingston Cotton Mills (1896) and Westminster Road Construction and Engineering Company Ltd. (1932), it has been held that "it is no part of the Auditor's duty to physically verify the stock. He can rely upon statements and reports made available to him in regard to the valuation of stocks as long as there is no circumstance, which may arouse his suspicion."

CARO requirements: The Management is required to conduct physical verification of inventories at reasonable intervals. Under CARO, the Auditor has to report on the following aspects -

(a) Whether physical verification of stock has been conducted by the Management at reasonable intervals?

(b) Whether the procedures of physical verification of stocks followed by Management are reasonable and adequate in relation to size of the Company and nature of its business?

(c) Whether the Company is maintaining proper records of inventory?

(d) Whether material discrepancies, if any, noticed in physical verification have been properly dealt with in the books of account?

Auditors' Role - Need for due care:

(a) Management Responsibility: The verification of inventories by physical count is primarily the duty of the Management. The Auditor is not required to carry out such verification and also he is not professionally qualified to do so on account of his lack of technical knowledge.

(b) Due Care and Expertise: The Auditor is expected to exercise reasonable care and skill to satisfy himself that - (i) the procedures laid down by Management are adequate and reasonable, and (ii) the valuation as placed by the Management is fair and proper.

(c) Negligence: The Auditor would be failing in his duty if he does not take reasonable care in verifying the Stock Statements, which are put up to him, having regard to the information in his possession and the expert knowledge expected of him as regards methods of stock verification.

(d) Working Papers: The Auditor should maintain in his Audit File - (i) a summary of inventory, and (ii) details regarding the extent of his verification.

(e) Management Representation: The Auditor should obtain a certificate concerning the existence, title and value of the inventories and containing details of charges, if any, created against them, from the Management.