Paper-12 : COMPANY ACCOUNTS & AUDIT

Study Note 1: Conceptual Framework for Preparation and Presentation of Financial Statements

Question No. 1

Discuss the use of the General Purpose Financial Statement and its shortcomings.

The conceptual Framework for Financial Reporting has the following uses of the general purpose financial statements by the cross-section of users:

(a) to decide when to buy, hold or sell any equity investment,
(b) to assess the accountability of management,
(c) to assess the ability of the entity to pay and provide other benefits to its employees,
(d) to assess the security for amounts lent to the entity,
(e) to determine taxation policies,
(f) to determine distributable profits and dividends,
(g) to prepare and use national income statistics,

Important shortcoming of financial statements is that they are prepared to meet the common information needs of a wide range of users. They may fall short of specific information needs of the users.
To meet the above – stated uses, financial statements provide information about an entity's assets, liabilities, equity, and income and expenses, including gains and losses, other changes in equity and cash flows.
That information, along with other information in the notes, assists users of financial statements in predicting amount, timing and degree of certainty of the entity's future cash flows.

Study Note 2: accounting Standards

Question No. 2

Best Ltd. has initiated a lease for three years in respect of an equipment costing ₹ 1,50,000 with expected useful life of 4 years. The asset would revert to Best Limited under the lease agreement. The other information available in respect of lease agreement is:

(i) The unguaranteed residual value of the equipment after the expiry of the lease term is estimated at ₹20,000.
(ii) The implicit rate of interest is 10%.
(iii) The annual payments have been determined in such a way that the present value of the lease payment plus the residual value is equal to the cost of asset.

Ascertain in the hands of Best Ltd.

(i) The annual lease payment.
(ii) The unearned finance income.
(iii) The segregation of finance income, and also,
(iv) Show how necessary items will appear in its profit and loss account and balance sheet for the various years.

Answer:

(i) Calculation of Annual Lease Payment

	₹
Cost of the equipment	1,50,000
Unguaranteed Residual Value	20,000
PV of residual value for 3 years @ 10% (₹ 20,000 x 0.751)	15,020
Fair value to be recovered from Lease Payment (₹1,50,000 – ₹15,020)	1,34,980
PV Factor for 3 years @ 10%	2.487
Annual Lease Payment (₹ 1,34,980/ PV Factor for 3 years @ 10% i.e. 2.487)	54,275
(ii) Unearned Financial Income	
Total lease payments [₹ 54,275 x 3]	1,62,825
Add: Residual value	20,000
Gross Investments	1,82,825
Less: Present value of Investments (₹ 1,34,980 + ₹ 15,020)	1,50,000
Unearned Financial Income	32,825

(iii) Segregation of Finance Income

Year	Lease Rentals ₹	Finance Charges @ 10% on outstanding amount of the year ₹	Repayment ₹	Outstanding Amount ₹
0	-	-	-	1,50,000
I	54,275	15,000	39,275	1,10,725
II	54,275	11,073	43,202	67,523
III	74,275	6,752	67,523	--
	1,82,825	**32,825**	**1,50,000**	

(iv) Profit and Loss Account (Extracts) Credit side ₹

I Year By Finance Income	15,000
II year By Finance Income	11,073
III year By Finance Income	6,752

Balance Sheet (Extracts)

Assets side

	₹	₹
I year Lease Receivable	1,50,000	
Less: Amount Received	39,275	1,10,725
II year Lease Receivable	1,10,725	
Less: Received	43,202	67,523
III year :Lease Amount Receivable	67,523	

Less: Amount received	47,523	
Residual value	20,000	NIL

Question No. 3

(a)

X Co. Ltd. supplied the following information. You are required to compute the basic earnings per share: Accounting year 1.1.2013 – 31.12.2013)		
Net Profit	**:**	**Year 2013 : ₹ 20,00,000**
	:	**Year 2014 : ₹ 30,00,000**
No. of shares outstanding prior to Right Issue	**:**	**10,00,000 shares**
Right Issue	**:**	**One new share for each four outstanding i.e., 2,50,000 shares.**
		Right Issue price – ₹ 20
		Last date of exercise rights – 31.3.2014.
Fair rate of one Equity share immediately prior to exercise of rights on 31.3.2014	**:**	**₹ 25**

Answer:

Computation of Basic Earnings Per Share

(as per paragraphs 10 and 26 of AS 20 on Earnings Per Share)

	Year 2013	Year 2014
	₹	₹
EPS = EPS for the year 2013 as originally reported		
$= \dfrac{\text{Net profit of the year attributable to equity shareholders}}{\text{Weighted average number of equity shares outstanding during the year}}$		
= (₹ 20,00,000 / 10,00,000 shares)	2.00	

EPS = EPS for the year 2013 restated for rights issue		
= [₹ 20,00,000 / (10,00,000 shares × 1.04)] (Refer working note.2)	1.92 (approx.)	
EPS = EPS for the year 2014 including effects of rights issue		
$\dfrac{₹\ 30{,}00{,}000}{(10{,}00{,}000 \text{ shares} \times 1.04 \times 3/12) + (12{,}50{,}000 \text{ shares} \times 9/12)}$		
$\dfrac{₹\ 30{,}00{,}000}{11{,}97{,}500 \text{ shares}}$		2.51 (approx.)

Working Notes:

1. **Computation of theoretical ex-rights fair value per share**

$$\frac{\text{Fair value of all outstanding shares immediately prior to exercise of rights} + \text{Total amount received from exercise}}{\text{Number of shares outstanding prior to exercise} + \text{Number of shares issued in the exercise}}$$

$$= \frac{(₹25 \times 10{,}00{,}000 \text{ shares}) + (₹\ 20 \times 2{,}50{,}000 \text{ shares})}{10{,}00{,}000 \text{ shares} + 2{,}50{,}000 \text{ shares}}$$

$$= \frac{₹\ 3{,}00{,}00{,}000}{12{,}50{,}000 \text{ shares}} = ₹\ 24$$

2. **Computation of adjustment factor**

$$= \frac{\text{Fair value per share prior to exercise of rights}}{\text{Theoretical ex-rights value per share}}$$

$$= \frac{₹\ 25}{₹\ 24 \text{ (Refer Working Note 1)}} = 1.04 \text{ (approx.)}$$

(b) A Ltd. leased a machinery to B Ltd. on the following terms:

	(₹ in Lakhs)
Fair value of the machinery	**20.00**
Lease term	**5 years**
Lease Rental per annum	**5.00**
Guaranteed Residual value	**1.00**
Expected Residual value	**2.00**
Internal Rate of Return	**15%**

Depreciation is provided on straight line method @ 10% per annum. Ascertain unearned financial income and necessary entries may be passed in the books of the Lessee in the First year.

Answer:

Computation of Unearned Finance Income

As per AS 19 on Leases, **unearned finance income** is the difference between (a) the **gross investment** in the lease and (b) the present value of minimum lease payments under a finance lease from the standpoint of the lessor; and any unguaranteed residual value accruing to the lessor, at the interest rate implicit in the lease.

where :

(i) **Gross investment** in the lease is the aggregate of (i) minimum lease payments from the stand point of the lessor and (ii) any unguaranteed residual value accruing to the lessor.

Gross Investment = Minimum lease payments + Unguaranteed residual value

= (Total lease rent + Guaranteed residual value) + Unguaranteed residual value

= [(₹ 5,00,000 × 5 years) + ₹ 1,00,000] + ₹ 1,00,000 = ₹ 27,00,000

(ii) **Table showing present value of (i) Minimum lease payments (MLP) and (ii) Unguaranteed residual value (URV).**

Year	MLP inclusive of URV	Internal rate of return (Discount factor 15%)	Present Value	
	₹		₹	
1	5,00,000	0.8696	4,34,800	
2	5,00,000	0.7561	3,78,050	
3	5,00,000	0.6575	3,28,750	
4	5,00,000	0.5718	2,85,900	
5	5,00,000	0.4972	2,48,600	
	1,00,000	0.4972	49,720	
	(Guaranteed residual value)			
			17,25,820	
	1,00,000	0.4972	49,720	
	(Unguaranteed residual value)			
			17,75,540	

Unearned Finance Income = (i) – (ii)

= ₹ 27,00,000 – ₹ 17,75,540 = ₹ 9,24,460

Journal Entries in the books of B Ltd.

		Debit (₹)	Credit (₹)
At the inception of lease			
	Machinery account Dr.	17,25,820	
	To A Ltd.'s account		17,25,820
	(Being lease of machinery recorded at present value of MLP)		
At the end of the first year of lease			

	Finance charges account (Refer Working Note) Dr.	2,58,873	
	To A Ltd.'s account		2,58,873
	(Being the finance charges for first year due)		
	A Ltd.'s account Dr.	5 ,00,000	
	To Bank account		5,00,000
	(Being the lease rent paid to the lessor which includes outstanding liability of ₹ 2,41,127 and finance charge of ₹ 2,58,873)		
	Depreciation account Dr.	1,72,582	
	To Machinery account		1,72,582
	(Being the depreciation provided @ 10% p.a. on straight line method)		
	Profit and loss account Dr.	4,31,455	
	To Depreciation account		1,72,582
	To Finance charges account		2,58,873
	(Being the depreciation and finance charges transferred to profit and loss account)		

Working Note:
Table showing apportionment of lease payments by B Ltd. between the finance charges and the reduction of outstanding liability.

Year	Outstanding liability (opening balance)	Lease rent	Finance charge	Reduction in outstanding liability	Outstanding liability (closing balance)
	₹	₹	₹	₹	₹
1	17,25,820	5,00,000	2,58,873	2,41,127	14,84,693
2	14,84,693	5,00,000	2,22,704	2,77,296	12,07,397
3	12,07,397	5,00,000	1,81,110	3,18,890	8,88,507
4	8,88,507	5,00,000	1,33,276	3,66,724	5,21,783
5	5,21,783	5,00,000	78,267	5,21,783	1,00,050*
			8,74,230	17,25,820	

The difference between this figure and guaranteed residual value (₹ 1,00,000) is due to approximation in computing the interest rate implicit in the lease.

Question No. 4

(a) Swift Ltd. acquired a patent at a cost of ₹ 80,00,000 for a period of 5 years and the product life-cycle is also 5 years. The company capitalized the cost and started amortizing the asset at ₹ 10,00,000 per annum. After two years it was found that the product life-cycle may continue for another 5 years from then. The net cash flows from the product during these 5 years were expected to be ₹ 36,00,000,₹ 46,00,000, ₹ 44,00,000, ₹ 40,00,000 and ₹ 34,00,000. Find out the amortization cost of the patent for each of the years.

Answer:

Swift Limited amortised ₹ 10,00,000 per annum for the first two years i.e. ₹ 20,00,000. The remaining carrying cost can be amortized during next 5 years on the basis of net cash flows arising from the sale of the product. The amortisation may be found as follows:

Year	Net cash flows ₹	Amortization Ratio	Amortization Amount ₹
I	-	0.125	10,00,000
II	-	0.125	10,00,000
III	36,00,000	0.180	10,80,000
IV	46,00,000	0.230	13,80,000
V	44,00,000	0.220	13,20,000
VI	40,00,000	0.200	12,00,000
VII	34,00,000	0.170	10,20,000
Total	**2,00,00,000**	**1.000**	**80,00,000**

It may be seen from above that from third year onwards, the balance of carrying amount i.e., ₹ 60,00,000 has been amortized in the ratio of net cash flows arising from the product of Swift Ltd.

Note: The answer has been given on the basis that the patent is renewable and Swift Ltd. got it renewed after expiry of five years.

(b) A Ltd. purchased fixed assets costing ₹ 5,100 lakhs on 1.1.13 and the same was fully financed by foreign currency loan (U.S. Dollars) payable in three annual equal installments. Exchange rates were 1 Dollar = ₹ 42.50 and ₹ 45.00 as on 1.1.13 and 31.12.13 respectively. First installment was paid on 31.12.13. The entire difference in foreign exchange has been capitalized.

You are required to state, how these transactions would be accounted for.

Answer:

(b) As per 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:

$$\text{Foreign currency loan} = \frac{₹\ 5{,}100\ \text{lakhs}}{₹\ 42.50} = 120\ \text{lakhs US Dollars}$$

Exchange difference = ₹120 lakhs US Dollars × (45.00 – 42.50)

= ₹ 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.

Question No. 5

(a) At the end of the financial year ending on 31st December, 2014, a company finds that there are twenty law suits outstanding which have not been settled till the date of approval of accounts by the Board of Directors. The possible outcome as estimated by the Board is as follows:

	Probability	Loss (₹)
In respect of five cases (Win)	100%	–
Next ten cases (Win)	60%	–
Lose (Low damages)	30%	1,20,000
Lose (High damages)	10%	2,00,000
Remaining five cases		
Win	50%	–
Lose (Low damages)	30%	1,00,000
Lose (High damages)	20%	2,10,000

Outcome of each case is to be taken as a separate entity. Ascertain the amount of contingent loss and the accounting treatment in respect thereof.

Answer:

According to AS 29 'Provisions, Contingent Liabilities and Contingent Assets', contingent liability should be disclosed in the financial statements if following conditions are satisfied:

(i) There is a present obligation arising out of past events but not recognized as provision.

(ii) It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation.

(iii) The possibility of an outflow of resources embodying economic benefits is also remote.

(iv) The amount of the obligation cannot be measured with sufficient reliability to be recognized as provision.

In this case, the probability of winning of first five cases is 100% and hence, question of providing for contingent loss does not arise. The probability of winning of next ten cases is 60% and for remaining five cases is 50%. As per AS 29, we make a provision if the loss is probable. As the loss does not appear to be probable and the possibility of an outflow of resources embodying economic benefits is not remote rather there is reasonable possibility of loss, therefore disclosure by way of note should be made. For the purpose of the disclosure of contingent liability by way of note, amount may be calculated as under:

Expected loss in next ten cases = 30% of ₹ 1,20,000 + 10% of ₹ 2,00,000

= ₹ 36,000 + ₹ 20,000 = ₹ 56,000

Expected loss in remaining five cases = 30% of ₹ 1,00,000 + 20% of ₹ 2,10,000

= ₹ 30,000 + ₹ 42,000 =₹ 72,000

To disclose contingent liability on the basis of maximum loss will be highly unrealistic.

Therefore, the better approach will be to disclose the overall expected loss of ₹ 9,20,000 (₹ 56,000 × 10 + ₹ 72,000 × 5) as contingent liability.

Question No. 6

MLN Ltd. is developing a new production process. During the financial year 31st March, 2013, the total expenditure incurred on this process was ₹105 lakhs. The production process met the criteria for recognition as an intangible asset on 1st December, 2012. Expenditure incurred till this date was ₹ 48 lakhs.

Further expenditure incurred on the process for the financial year ending 31st March, 2014 was ₹80 lakhs. As at 31 March, 2014, the recoverable amount of know-how embodied in the process is estimated to be ₹165 lakhs. This includes estimates of future cash outflows as well as inflows.

You are required to work out:

(i) What is the expenditure to be charged to the profit and loss account for the financial year ended 31st March, 2013? (Ignore depreciation for this purpose)

(ii) What is the carrying amount of the intangible asset as at 31st March, 2013?

(iii) What is the expenditure to be charged to profit and loss account for the financial year ended 31st March, 2014? (Ignore depreciation for this purpose)

(iv) What is the carrying amount of the intangible asset as at 31st March, 2014?

Answer:

(a) Expenditure incurred up to 1-12-2012 will be taken up to profit and loss account for the financial year ended 31-3-2013 = ₹ 48 lakhs.

(b) Carrying amount as on 31-3-2013 will be the expenditure incurred after 1-12-2012 = ₹ 57 lakhs.

(c) Book cost of intangible asset as on 31-3-2011 is worked out as:

Carrying amount as on 31-3-2013	- ₹ 57 lakhs
Expenditure during 2013-14	- ₹ 80 lakhs
Total Book Cost	- ₹ 137 lakhs
Recoverable amount, as estimated	- ₹ 165 lakhs

Difference to be charged to profit and loss account as impairment – Nil.

(d) Carrying amount of the Intangible Asset as on 31.3.2014 will be ₹137 lakhs.

Study Note 3: Accounting for Shares and Debentures

Question No. 7

Summer & Cool Ltd. planned to set up a unit for manufacture of bulk drugs. For the purpose of financing the unit, the Board of Directors have issued 10,00,000 Equity Shares of ₹10 each. 25% of the issue was reserved for Promoters and the balance was offered to the public. A Ltd., B Ltd. and C Ltd. have come forward to underwrite the public issue in the ratio of 3:2:1 and also agreed for Firm Underwriting of 25,000, 17,500, 7,500 Shares respectively. The Underwriting Commission was fixed at 5%. The amount payable on application was ₹ 2.50 per share. The details of subscriptions are:

Particulars	Marked Forms of A	Marked Forms of B	Marked Forms of C
No. of Shares	3,25,000	1,50,000	1,00,000

Unmarked Forms were received for 60,000 Shares. From the above, you are required to show the allocation of liability among underwriters with workings. Also, pass Journal Entries in the books of the Company for

a. Underwriters' net liability and the receipt or payment of cash to or from Underwriters.

b. Determining the liability towards the payment of commission to the Underwriters.

Answer:

Computation of liability of underwriters (No. of shares):

Particulars	A	B	C	Total
Gross Liability (3:2:1)	3,75,000	2,50,000	1,25,000	7,50,000
Less: Firm underwriting	25,000	17,500	7,500	50,000
	3,50,000	2,32,500	1,17,500	7,00,000
Less: Marked application	3,25,000	1,50,000	1,00,000	11,50,000
	25,000	82,500	17,500	1,25,000
Less: Unmarked applications distributed to A, B and C in 3:2:1 ratio	30,000	20,000	10,000	60,000
	(5,000)	62,500	7,500	65,000
Less: Surplus of A distributed to B & C in 2:1 ratio	5,000	3,333	1,667	
Net Liability (excluding firm underwriting)	Nil	59,167	5,833	65,000
Add: Firm underwriting	25,000	17,500	7,500	50,000
Total Liability (No. of Shares)	25,000	76,667	13,333	1,15,000

(a) Computation of amounts receivable from / payable to underwriters:

Particulars	P	Q	R	Total
a. Total Liability (incl. Firm underwriting) (share)	25,000	76,667	13,333	1,15,000
b. Amount due at 2.50 per share (a x 2.50)	62,500	1,91,667	33,333	2,87,500
c. Amount paid for firm Underwriting at 2.50 per	62,500	43,750	18,750	1,25,000

share				
d. Balance due from Underwriters (b-c)	Nil	1,47,917	14,583	1,62,500
e. Underwriting commission payable by company	3,75,000 x 10 x 5% =1,87,500	2,50,000 x 10 x 5% =1,25,000	1,25,000 x 10 x 5% =62,500	3,75,000
f. Amount due to / (payable by) co. (d-e)	(1,87,500)	22,917	(47,917)	(2,12,500)

(b) In the Books of Summer & Cool Ltd.

Journal Entries

Particulars	Dr.	Cr.
Bank A/c To Equity Share Capital A/c A Ltd – 25,000 x 2.5 B Ltd – 17,500 x 2.5 C Ltd – 7,500 x 2.5 (Being allotment of shares against amounts received towards subscription for Firm Underwriting at 25,000 ; 17,500 and 7,500 shares respectively from A, B, C at ₹2.50)	1,25,000	 62,500 43,750 18,750
B A/c (59,1667 x 2.50) C A/c (5,833 X 2.50) To Equity Share Capital A/c (Being allotment of share to underwriters. Application and allotment money credited to Equity Share Capital A/c)	1,47,917 14,583	 1,62,500
Underwriting Commission A/c To A A/c To B A/c To C A/c (Being the underwriting Commission payable to A,B and C at 5% of the normal value of the share underwritten)	3,75,000	 1,87,500 1,25,000 62,500
A A/c C A/c To Bank A/c (Being the amount paid to A and C in final settlement of underwriting commission due less amount receivable from them on share allotted)	1,87,500 47,917	 2,3,5,417
Bank A/c To B A/c (Being the amount received from B on shares allotted less underwriting Commission payable to him)	22,917	 22,917

Question No. 8

Journalize the following transactions. Narration is not required:

Issue of 15% 1,00,000 debentures of ₹100 each

i. at par and redeemable at par.
ii. at 10% discount and redeemable at par.
iii. at 10% premium and redeemable at par.

iv. at 10% premium and redeemable at a premium of 5%.
v. at par and redeemable at a premium of 5%.
vi. at 10% discount and redeemable at a premium of 5%.

Answer:

Journal

			Debits	**Credits**
	Particulars		₹'000	₹'000
i.	Bank Account	Dr.	10,000	
	To 15% Debentures Account			10,000
ii.	Bank Account	Dr.	9,000	
	Discount on Issue of Debentures Account	Dr.	1,000	
	To 15% Debentures Account			10,000
iii.	Bank Account	Dr.	11,000	
	To 15% Debentures Account			10,000
	To Securities Premium Account			1,000
iv.	Bank Account	Dr	11,000	
	Loss on issue of debenture	Dr	500	
	To 15% Debentures Account			10,000
	To Securities Premium Account			1,000
	To Prem. on redemption of debentures			500
v.	Bank Account	Dr.	10,000	
	Loss on issue of Debentures Account	Dr.	500	
	To 15% Debentures Account			10,000
	To Prem. on redemption of Debentures			500
vi.	Bank Account	Dr.	9,000	
	Loss on Issue of Debentures Account **	Dr.	1,500	
	To 15% Debentures Account			10,000
	To Prem. on redemption of Debentures			500

** This amount includes ₹1,000 discount on issue of debentures and ₹500 premium on redemption.

Question No. 9

(a) The following particulars in respect of stock options granted by a company are available:

Grant date	**April 1, 2011**
Number of employee covered	**50**
Number of option granted per employee	**1000**
Fair value of option per share on grant date (₹)	**9**

The option will vest to employees serving continuously for 3 years from vesting date, provided the share price is ₹70 or above at the end of 2013-14.

The estimates of number of employees satisfying the condition of continuous employment were 48 on 31.03.2012 & 47 on 31.3.2013. The number of employees actually satisfying the condition of continuous employment was 45.

The share price at the end of 2013-14 was ₹68.

Compute expenses to recognize in each year and show important accounts in books of the company.

Answer:

The vesting of options is subject to satisfaction of two conditions viz. service condition of continuous employment for 3 years and market condition that the share price at the end of 2013-14 is not less than ₹70.

Since the share price on 31/03/14 was ₹68, the actual vesting as nil. Despite this, the company should recognise value of option over 3 - year vesting period from 2011-12 to 2013-14.

Year 2011-12

Fair value of option per share = ₹9

Number of shares expected to vest under the scheme = 48 x 1,000 = 48,000

Fair value = 48,000 x ₹9 = ₹4,32,000

Expected vesting period = 3 years

Value of option recognised as expense in 2009-10 = ₹4,32,000 /3 = ₹1,44,000

Year 2012-13

Fair value of option per share = ₹9

Number of shares expected to vest under the scheme = 47 x 1,000 = 47,000

Fair value = 47,000 x ₹9 =₹4,23,000

Expected vesting period = 3 years

Cumulative value of option to recognise as expense in 2011-12 and 2012-13

= (₹4,23,000/3) x 2 = ₹2,82,000

Value of option recognised as expense in 2011-12 = ₹1,44,000

Value of option recognised as expense in 2012-13

= ₹2,82,000 - ₹1,44.000 = 1,38,000

Year 2013-14

Fair value of option per share = ₹9

Number of shares actually vested under the scheme = 45 x 1,000 = 45,000

Fair value = 45,000 x ₹9 = 4,05,000

Vesting period = 3 years

Cumulative value of option to recognise as expense in 2011-12, 2012-13 and 2013-14

= ₹4,05,000

Value of option recognised as expense in 2011-12 and 2012-13 = ₹2,82,000

Value of option recognised as expense in 2013-14

= ₹4,05,000 - ₹ 2,82,000 = ₹1,23,000

Employees' Compensation Account

Year	Particulars	Amount	Year	Particulars	Amount
2011-12	To ESOP Outstanding A/c	1,44,000	2011-12	By Profit & Loss A/c	1,44,000
		1,44,000			1 44 000
2012-13	To ESOP Outstanding A/c	1,38,000	2012-13	By Profit & Loss A/c	1,38,000
		1,38,000			1,38,000
2013-14	To ESOP Outstanding A/c	1,23,000	2013-14	By Profit & Loss A/c	1,23,000

		1,23,000			1,23,000

ESOP Outstanding Account

Year	Particulars	Amount	Year	Particulars	Amount
2011-12	To Balance b/d	1,44,000	2011-12	By Employees' Compensation A/c	1,44,000
		1,44,000			1,44,000
2012-13	To Balance c/d	2,82,000	2012-13	By Balance b/d	1,44,000
				By Employees' Compensation A/c	1,38,000
		2,82,000			2,82,000
2013-14	To General Reserve A/c	4,05,000	2013-14	By Balance b/d	2,82,000
				By Employees' Compensation A/c	1,23,000
		4,05,000			4,05,000

(b) A Company has its Share Capital divided into Shares of ₹10 each. On 1st April 2013, it granted 20,000 Employees' Stock Options at ₹ 40, when the Market Price was ₹ 130. The Options were to be exercised between 1st January 2014 to 15th March 2014. The Employees exercised their Options for 18,500 Shares only, the remaining options lapsed. The Company closes its books on 31st March every year. Pass Journal Entries with regard to Employees' Stock Option.

Answer:

1. Computation of Expense to be recognised (Vesting Period = 1 month)

Particulars	Result
Fair Value of Option per Share = MPS on Grant Date ₹ 130 less Exercise Price ₹ 40	₹ 90
No. of Shares vesting under the Scheme = given	18,500 Shares
Total Fair Value of Options = 18,500 x ₹ 90, to be recognised as Expense	₹ 16,65,000

2. Journal Entry for ESOP

Particulars	Dr. (₹)	Cr. (₹)

Bank A/c (18,500 Shares x ₹ 40) Dr.	7,40,000	
Employees' Compensation Expense A/c (18,500 Shares x ₹ 90) Dr.	16,65,000	
To Equity Share Capital A/c (18,500 Shares x ₹ 10)		1,85,000
To Securities Premium A/c (18,500 Shares x ₹ 120)		22,20,000
(Being 18,500 Shares allotted to Employees under ESOP at a Premium of ₹ 120 per Share)		

Study Note 4: Presentation of Financial Statements (as per Revised Schedule VI)

Question No.10

From the following particulars of Pintop Ltd. you are required to calculate the Managerial Remuneration in the following situations:

- **There is only one Whole Time Director.**
- **There are two Whole Time Directors.**
- **There are two Whole Time Directors, a part time Director and a Manager.**

Particulars	**₹**
Net Profit before Income Tax and Managerial Remuneration, but after Depreciation and Provision for Repairs	**17,40,820**
Depreciation provided in the Books	**6,20,000**
Provision for Repairs for Machinery during the year	**50,000**
Depreciation Allowable under Schedule XIV	**5,20,000**
Actual Expenditure incurred on Repairs during the year	**30,000**

Answer:

A. Computation of Net Profits u/s 349 of the Companies Act

Particulars	₹
Net Profit before Provision for Income-tax and Managerial Remuneration, but after Depreciation and Provision for Repairs	17,40,820
Add: Depreciation provided in the Books	6,20,000
	23,60,820
Less: Depreciation allowable under Schedule XIV	(5,20,000)
Net Profits under Section 349	18,40,820

Note: While computing the Net Profit u/s 349:

- All usual working charges will be allowed.
- Expenses on repairs, whether to movable / immovable property provided the repairs are not of capital nature will be allowed.
- Provision for Repairs of Machinery are usual working charges and hence allowed for computing Net Profit u/s 349.

B. Computation of Managerial Remuneration u/s 309

Situation	% of Remuneration	Managerial Remuneration
One Whole Time Director	5%	₹ 92,041.00
Two Whole Time Directors	10%	₹ 1,84,082.00
Two Whole Time Directors and Part Time Director and a Manager	11%	₹ 2,02,490.20

Study Note 5: Cash Flow Statement (AS 3)

Question No. 11

(a) The following is the income statement XYZ Company for the year 2012-13:

(₹)

Sales			**1,62,700**
***Add*: Equity In ABC Company's earning**			**6,000**
			1,68,700
Expenses		**(₹)**	
Cost of goods sold		**89,300**	
Salaries		**34,400**	
Depreciation		**7,450**	
Insurance		**500**	
Research and development		**1,250**	
Patent amortisation		**900**	
Interest		**10,650**	
Bad debts		**2,050**	
Income tax :			
Current	**6,600**		
Deferred	**1,650**	**8,250**	
Total expenses			**1,54,650**
Net income			**14,050**

Additional information are:

(i) 70% of gross revenue from sales were on credit.

(ii) Merchandise purchases amounting to ₹ 92,000 were on credit.
(iii) Salaries payable totaled ₹ 1,600 at the end of the year.
(iv) Amortisation of premium on bonds payable was ₹ 1,350.
(v) No dividends were received from the other company.
(vi) XYZ Company declared cash dividend of ₹ 4,000.
(vii) Changes in Current Assets and Current Liabilities were as follows:

	Increase (Decrease)
	₹
Cash	**500**
Marketable securities	**1,600**
Accounts receivable	**(7,150)**
Allowance for bad debt	**(1,900)**
Inventory	**2,700**
Prepaid insurance	**700**
Accounts payable (for merchandise)	**5,650**
Salaries payable	**(2,050)**
Dividends payable	**(3,000)**

Prepare a statement showing the amount of cash flow from operations.

Answer:

Statement showing cash flow from Operations

	₹	₹
Cash flow from operations		
Cash sales (30% 1,62,700)	48,810	
Collection from debtors	1,20,890	
Total cash from operations		1,69,700
Uses of cash from operations		
Payment to suppliers	86,350	
Salaries expense	36,450	
Payment for insurance	1,200	
Research and development	1,250	
Interest payment	12,000	

Income tax payment	6,600	
Total operating cash payment		1,43,850
Net cash flow from operations		25,850

Notes:

(1)	Collection from debtors		₹
	Credit sales (70%× 1,62,700)		1,13,890
	Less : Bad debts (2,050 less 1,900)		150
			1,13,740
	Add : decrease in accounts receivables		7,150
	Collection from debtors on credit sales		1,20,890
(2)	Dividends earned ₹ 6,000 on equity of ABC Company		
	has not been considered as it has not been received in cash.		
		₹	
(3)	Payment to suppliers		
	Cost of goods sold	89,300	
	Add: Increase in inventory	2,700	
	Purchases	92,000	
	Less: increase in accounts payable	5,650	
	Payment to suppliers	86,350	
(4)	Calculation of salaries payment		
	Salary expense	34,400	
	Add : decrease in salary payable	2,050	
	Payment of salaries	36,450	
(5)	Insurance payments		
	Insurance	500	
	Add : increase in prepaid insurance	700	
	Payment for insurance	1,200	
(6)	Interest payment		
	Interest expenses	10,650	
	Add : Amortisation of bond premium	1,350	
	Interest payments	12,000	

(7)	Income tax payments	₹	
	Income tax expense	8,250	
	Less: Deferred tax	1,650	
		6,600	
	Changes in current tax payable	Nil	
	Income tax payments	6,600	

(b) Discuss the Importance of Cash flows.

Answer:

Cash flows are crucial to business decisions. Cash is invested in the business and the rationality of such investment is evaluated taking into account the future cash flows it is expected to generate. Economic value of an asset is derived on the basis of its ability to generate future cash flows. Economic value of an asset is given by the present value of future cash flows expected to be derived from the asset.

Profit is an accounting concept. Profit is derived on accrual assumption. Profit and cash flows from operational activities are not the same. Dividend decision is taken on the basis of profit, although it is to be paid in cash. Similarly, debt servicing capacity of a company is determined on the basis of cash flows from operations before interest. Plugging back of profit is a much talked about source of financing modernisation, expansion and diversification. Unless retained profit is supported by cash, plugging back is not possible. Thus cash flows analysis is an important basis for making several management decisions.

Question No. 12

X Ltd. has the following balances as on 1st April, 2012

	₹
Fixed Assets	**16,40,000**
Less: Depreciation	**4,36,000**
	12,04,000
Stocks and Debtors	**7,25,000**
Bank Balance	**1,22,500**
Creditors	**2,24,000**
Bills payable	**1,76,000**
Capital (Shares of ₹100 each)	**7,50,000**

The Company made the following estimates for financial year 2012-13:

(i) The company will pay a free of tax dividend of 20% the rate of tax being 30%.

(ii) The company will acquire fixed assets costing ₹3,20,000 after selling one machine for ₹45,000 costing ₹1,95,000 and on which depreciation provided amounted to ₹1,66,500.

(iii) Stocks and Debtors, Creditors and Bills payables at the end of financial year are expected to be ₹6,70,000, ₹1,88,000 and ₹1,52,800 respectively.

(iv) The profit would be ₹2,04,500 after depreciation of ₹2,14,000.

Prepare the projected cash flow statement and ascertain the bank balance of X Ltd. at the end of Financial year 2012-13.

Answer:

Working:

(i) Cash Flow from Operation	₹
Profit for the year	2,04,500
Add: Depreciation (Non-cash Item)	2,14,000
	4,18,500
Less: Profit on sale of Machine	16,500
	4,02,000
Add: Increase in stocks & Debtors (₹7,25,000 – ₹6,70,000)	55,000
	4,57,000
Less: Decrease in	
Creditors (₹2,24,000 - ₹1,88,000)	36,000
Bills Payable (₹1,76,000 – ₹152,800)	23,200
Cash from Operations	3,97,800
(ii) Payment of Dividend	
20% on Capital ₹7,50,000	1,50,000
Tax 30%	45,000
Total Dividend	1,95,000

It is assumed that income tax on company's profit ignore.

Projected cash flow statement for the year ended on 31st March, 2013

	₹	₹
Bank Balance as on 1st April, 2012		1,22,500
Add: Inflow of cash		
Sale of Machine	45,000	
Cash from operation	3,97,800	4,42,800
		5,65,300
Less: Outflow of Cash		
Purchase of Fixed Asssets	3,20,000	
Payament of Dividends	1,50,000	
Tax Paid	45,000	5,15,000
Bank Balance on 31st March, 2013		50,300

Study Note 6: Segmental Reporting (AS 17)

Question No. 13

(a) From the following information of a company having two primary segments, prepare a statement classifying the same under appropriate heads.

		(₹ in lakh)
Segment Revenue	A	27,150
Segment Revenue	B	3,280
Inter Segment Revenue	A	50
Segment Profit	A	4,640
	B	
Segment Profit	Loss	197
Dividend Income		285
Interest Expense		43
Tax Provision		1,675
Capital Expenditure	A	1,300
Capital Expenditure	B	16
Non Cash Expenses (excluding depreciation)		
Segment	A	114
Segment	B	16
Liabilities	A	3,430
Liabilities	B	770
Other Liabilities		2,200
Assets	A	19,450
Assets	B	2,700
Other Assets		6,550
Depreciation	A	110
Depreciation	B	15

Answer:

Particulars	Segment	Segment	Others	Eliminations	Total

		A	B			
I	Revenue:					
	a) External Revenue	27,150	3,280			30,430
	b) Inter segment Revenue	50			-50	
Total		27,200	3,280		-50	30,430
II	Result:	4,640	-197			4,443
	a) Income from Investment					285
	b) Interest Expenses					-43
	c) Tax provision					-1,675
	d) Net profit					3,010
III	Assets:					
	a) Segment assets (directly attributable & allocated)	19,450	2,700			22,150
	b) Unallocated assets					6,550
IV	Liabilities					
	a) Segment assets (directly attributable & allocated)	3,440	770			4,200
	b) Unallocated liabilities					2,200
V	Others:					
	a) Depreciation	110	15			125
	b) Non cash expenses	114	16			130
	c) Capital Expenditure	1,300	16			1,316

(b) Define Business Segment and Geographical Segment as per AS 17.

Answer:

Business segment -

A business segment is a distinguishable component of an enterprise that is engaged in providing an individual product or service or a group of related products or services and that is subject to risks and returns that are different from those of other business segments. Factors that should be considered in determining whether products or services are related include:

(a) the nature of the products or services;

(b) the nature of the production processes;

(c) the type or class of customers for the products or services;

(d) the methods used to distribute the products or provide the services; and

(e) if applicable, the nature of the regulatory environment, for example, banking, insurance, or public utilities.

Geographical segment -

A geographical segment is a distinguishable component of an enterprise that is engaged in providing products or services within a particular economic environment and that is subject to risks and returns that are different from those of components operating in other economic environments. Factors that should be considered in identifying geographical segments include:

(a) similarity of economic and political conditions;

(b) relationships between operations in different geographical areas;

(c) proximity of operations;

(d) special risks associated with operations in a particular area;

(e) exchange control regulations; and

(f) the underlying currency risks.

Study Note 7: Business Combinations and Corporate Restructuring

Question No.14

D Ltd. and Y Ltd. decide to amalgamate and to form a new company DY Ltd. The following are their balance sheets as at 31.3.2014:

Liabilities	D Ltd.	Y Ltd.	Assets	D Ltd.	Y Ltd.
Share Capital			Fixed Assets	3,75,000	1,00,000
(₹100) each	5,00,000	3,00,000	Investments:		
General Reserve	50,000	25,000	750 Shares in Y Ltd	1,75,000	–
Investment Allowance Reserve	20,000	15,000	2,000 Shares in D Ltd	–	2,50,000
12% Debentures	1,50,000	50,000	Current Assets	2,00,000	50,000
(₹100 each)					
Sundry Creditors	30,000	10,000			
	75,00,000	4,00,000		7,50,000	4,00,000

Calculate the amount of purchase consideration for D Ltd. and Y Ltd. after considering the following:

(i) Fixed assets of D Ltd. are to be reduced by ₹ 25,000 and that of Y Ltd. are to be taken at ₹ 1,50,000.

(ii) 12% debentureholders of D Ltd. and Y Ltd. are discharged by DY Ltd. by issuing such number of its 15% debentures of ₹ 100 each so as to maintain the same amount of interest.

(iii) Shares of DY Ltd. are of ₹ 100 each.

Answer:

Calculation of Purchase consideration

(i) Value of Net Assets of D Ltd. and Y Ltd. as on 31st March, 2014

		D Ltd.		Y Ltd.
		₹		₹
Assets taken over:				
Fixed Assets	3,50,000		1,50,000	
Current Assets	2,00,000	5,50,000	50,000	2,00,000
Less: Liabilities taken over:				
Debentures	1,20,000*		40,000**	
Sundry Creditors	30,000	1,50,000	10,000	50,000
		4,00,000		1,50,000

$$*1,50,000 \times \frac{12}{100} \times \frac{100}{15} = ₹\ 1,20,000$$

$$**\ 50,000 \times \frac{12}{100} \times \frac{100}{15} = ₹\ 40,000$$

(ii) Value of Shares of D Ltd. and Y Ltd.

The value of shares of D Ltd. is ₹ 4,00,000 plus 1/4 of the value of the shares of Y Ltd.

Similarly, the value of shares of Y Ltd. is ₹ 1,50,000 plus 2/5 of the value of shares of D Ltd.

Let a denote the value of shares of D Ltd. and m denote the value of shares of Y Ltd. then

a = 4,00,000 + 1/4 m ; and

m = 1,50,000 + 2/5 a.

Substituting the value of m,

a = 40,000 + 1/4 (1,50,000 + 2/5 a)

a = 4,00,000 + 37,500 + 1/10 a

9/10 a = 4,37,500

a = 4,86,111

m = 1,50,000 + 2/5 (4,86,111)

m = 3,44,444

(iii) Amount of Purchase Consideration

	D Ltd.	Y Ltd.
	₹	₹
Total value of shares (as determined above)	4,86,112	3,44,444
Less: Internal investments:		
2/5 for shares held by Y Ltd.	1,94,445	
1/4 for shares held by D Ltd.	______	86,111
Amount due to outsiders	2,91,667	2,58,333

Purchase Consideration will be satisfied by DY Ltd. as follows:

	D Ltd.	Y Ltd.
	₹	₹
In shares (of ₹ 100 each)	2,91,600	2,58,300
In cash	67	33

Question No. 15

M Ltd. is in the hands of a Receiver for debenture holders who holds a charge on all assets except uncalled capital. The following statement shows the position as regards creditors as on 31st March, 2014:

Liabilities	₹	Assets	₹
Share capital	3,60,000	Property, Machinery and Plant etc.	
in shares of ₹60 each ₹30 paid up	---	(Cost ₹3,90,000) estimated at	1,50,000
First Debentures		Cash in hand	2,70,000
Second Debentures	3,00,000	Investment	3,60,000
Unsecured Creditors	6,00,000	Uncalled Capital	1,80,000
	4,50,000	Deficiency	7,50,000
	17,10,000		17,10,000

A holds the First Debentures for ₹3,00,000 and Second Debentures for ₹3,00,000. He is also an unsecured creditor for ₹90,000. B holds Second Debentures for ₹3,00,000 and is an unsecured creditor for ₹60,000.
The following scheme of reconstruction is proposed:-

i. **A is to cancel ₹2,10,000 of the total debt owing to him, to advance ₹30,000 in cash and to take First Debentures (in cancellation of those already issued to him) for ₹5,10,000 in satisfaction of all his claims.**
ii. **B is to accept ₹90,000 in cash in satisfaction of all claims by him.**
iii. **Unsecured creditors (other than A and B) are to accept four shares of ₹7.50 each, fully paid in satisfaction of 75% of every ₹60 of their claim. The balance of 25% is to be postponed and to be payable at the end of three years from the date of Court's approval of the scheme. The nominal Share capital is to be increased accordingly.**
iv. **Uncalled capital is to be called up in full and ₹52. 50 per share cancelled, thus taking the shares of ₹7.50 each.**

Assuming that the scheme is duly approved by all parties interested and by the Court, give necessary journal entries and the Balance Sheet of the Company after the scheme has been carried into effect.

Answer:

WN # 1: Calculation of P & L Debit Balance at the time of Reconstruction

Liabilities	₹	Assets	₹
Share capital	1,80,000	Fixed Assets (Book Value)	3,90,000
First Debentures	3,00,000	Cash	2,70,000
Second Debentures	6,00,000	Profit and Loss A/c (Bal. Fig.)	8,70,000
Unsecured Creditors	4,50,000		
	17,10,000		

	Particulars	Debit (₹)	Credit (₹)
1.	Restructuring of A's liability:		
	a. Ascertainment of amount due		
	1st Debentures A/c Dr.	3,00,000	
	2nd Debentures A/c Dr.	3,00,000	
	Unsecured Creditors A/c Dr.	90,000	
	To A's A/c		6,90,000
	b. Waiver		
	A's A/c Dr.	2,10,000	
	To Reconstruction A/c		2,10,000
	c. Cash brought in		
	Bank A/c Dr.	30,000	
	To A's A/c		30,000
	d. Conversion of liability		
	A's A/c Dr.	5,10,000	
	To 1st Debentures A/c		5,10,000
2.	Restructuring of B's liability:		
	2nd Debentures A/c Dr.	3,00,000	
	Unsecured Creditors A/c Dr.	60,000	
	To Bank A/c		90,000
	To Reconstruction A/c		2,70,000
3.	Restructuring of other unsecured creditors*		
	(4,50,000 – 90,000 – 60,000 = 3,00,000)		
	Unsecured Creditors A/c Dr.	3,00,000	
	To Equity Share capital A/c		1,50,000
	To Loan (Unsecured) A/c		75,000
	To Reconstruction A/c		75,000
4.	Share Capital		
	a. Call money due:		
	Share call A/c Dr.	1,80,000	
	To Share capital A/c		1,80,000
	b. Share call Money received:		
	Bank A/c Dr.	1,80,000	
	To Share Call A/c		1,80,000
	c. Capital Reduction:	3,60,000	
	Equity Share Capital A/c (Face value ₹60) Dr.		
	To Equity Share capital (face value ₹7.50) A/c		45,000

	To Reconstruction A/c		3,15,000
5.	Utilisation of reconstruction surplus Reconstruction A/c Dr. To Profit and Loss A/c	8,70,000	 8,70,000
	a. Scheme of settlement unit of liability is b. 75% share (60 x 0.75) (i) 4 Equity shares @ ₹7.5 (ii) Waiver c. 25% share (60 x 0.25) [Can be carried forward as unsecured loan] Note: Liability is settled in the Ratio of 30:15:15 (i.e., 2:1:1)		60 45 30 15 15

Balance Sheet (and Reduced)

Liabilities	₹	Assets	₹
Share capital Debentures Unsecured Creditors	1,95,000 5,10,000 75,000	Fixed Assets (Book Value) Cash Profit and Loss A/c (Bal. Fig.)	3,90,000 2,70,000 8,70,000
	7,80,000		7,80,000

Reconstruction Account

Dr. Cr.

Particulars	₹	Particulars	₹
To Profit and Loss A/c	8,70,000	By A's A/c By B's A/c By Unsecured creditors By Equity Share Capital	2,10,000 2,70,000 75,000 3,15,000
	8,70,000		8,70,000

Cash/Bank Account

Dr. Cr.

Particulars	₹	Particulars	₹
To balance b/d To A's A/c To share call A/c	2,70,000 3,00,000 1,80,000	By B's A/c By Balance c/d	90,000 3,90,000
	4,80,000		4,80,000

Question No.16

The Balance Sheets of S Ltd. and H Ltd. as on 31.3.13 were as follows.

(₹ in Lakhs)

Liabilities	***S Ltd.***	***H Ltd.***
Equity Share capital	**160**	**50**
Reserves and surplus	**800**	**150**
10% 25,000 Debentures of ₹ 100 each	**–**	**50**
Other Liabilities	**240**	**–**

		1,200		250
Assets				
Fixed assets at cost	**400**		**150**	
Less: Depreciation	**<u>200</u>**	**200**	**<u>100</u>**	**50**
Investments in H Ltd.				
4 Lakhs Equity shares of ₹ 10				
each at cost	**64**			
10% 50,000 debentures of ₹ 100				
each at cost	**<u>48</u>**	**112**		
Current assets	**1,600**		**600**	
Less: Current liabilities	**<u>(712)</u>**	**888**	**<u>(400)</u>**	**200**
		1,200		**250**

In a scheme of absorption duly approved by the Court, the assets of 'H' Ltd. were taken over at an agreed value of ₹260 lakhs. The liabilities were taken over at par. Outside shareholders of 'H' Ltd. were allotted equity shares in S Ltd. at a premium of ₹ 90 per share in satisfaction of other claims in 'H' Ltd. for purposes of recording in the books of 'S' Ltd. Fixed assets taken over from 'H' Ltd. were revalued at ₹ 80 lakhs.

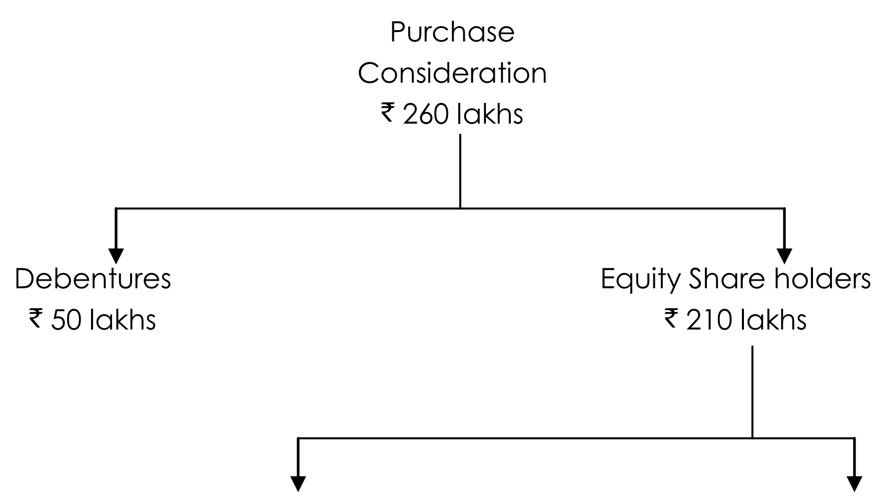
The scheme was put through on 1st April, 2013.

a. Journal Entries in the books of 'S' Ltd.

b. Show the balance of 'S' Ltd. after absorption of 'H' Ltd.

Answer:

WN # 1 : ***Purchase consideration of shares to be issued***



Worth of shares belonging to S Ltd. 4/5 × 210 = ₹168 lakhs	Amount Pertaining to outsiders ₹210 -₹168 = ₹ 42 lakhs*

‘Number of shares to be issued to outside shareholders @ 10/- each at a premium of ₹ 90/- $= \dfrac{₹\ 42,00,000}{100}$

= 42,000 Shares.

a) Part - II Journals in Books of S Ltd.

- Nature of Amlagamation - Purchase Method
- Method of Accounting - Purchase Method

(₹ in Lakhs)

	Particulars		***Debit***	***Credit***
i.	For Purchase Consideration Due :			
	To Liquidator for H Ltd.” A/c			42
	(Being the purchase consideration payable to liquidator of H Ltd. for business purchase)			
ii.	For assets and liabilities taken over:			
	Fixed Assets A/c	Dr.	80	
	Current Assets A/c	Dr.	600	
	To Current Liabilities A/c			400
	To Liability for 10% Debentures A/c			50
	To Business Purchase A/c			42
	To Investment in H Ltd. A/c			64
	To Capital Reserve (balancing figure)			124
	(Being the assets and liabilities taken over from H Ltd)			
iii.	Discharge of purchase consideration:			
	Liquidator of H Ltd. A/c	Dr.	42	
	To Equity Share Capital A/c			4.20
	To Securities Premium A/c			37.80
	(Being the allotment of 21 lakhs equity shares of ₹ 10 ₹90 per share.)			
iv.	Cancellation of Liability of Debentures:			

10% Debenetures A/c	Dr.	50	
To Investments in Debentures A/c			48
To Capital Reserve A/c			2
(Being the cancellation of debentures of H Ltd.)			

b)

Name of the Company: S Ltd.					
Balance Sheet as at 01.04.2013					
Ref No.	**Particulars**		**Note No.**	**As at 1st April, 2013**	**As at 1st April, 2012**
				(₹ in lakhs)	**(₹ in lakhs)**
	I.	Equity and Liabilities			
	1	Shareholders' funds			
		(a) Share capital	1	164.20	
		(b) Reserves and surplus	2	963.80	
		(c) Money received against share warrants			
	2	Share application money pending allotment			
	3	Non-current liabilities			
		(a) Long-term borrowings			
		(b) Deferred tax liabilities (Net)			
		(c) Other Long term liabilities			
		(d) Long-term provisions			
	4	Current Liabilities			
		(a) Short-term borrowings			
		(b) Trade payables			
		(c) Other current liabilities	3	1,352	
		(d) Short-term provisions			

		Total		2,480	
	II.	Assets			
	1	Non-current assets			
		(a) Fixed assets			
		(i) Tangible assets	4	280	
		(ii) Intangible assets			
		(iii) Capital work-in-progress			
		(iv) Intangible assets under development			
		(b) Non-current investments			
		(c) Deferred tax assets (Net)			
		(d) Long-term loans and advances			
		(e) Other non-current assets			
	2	Current assets			
		(a) Current investments			
		(b) Inventories			
		(c) Trade receivables			
		(d) Cash and cash equivalents			
		(e) Short-term loans and advances			
		(f) Other current assets	5	2,200	
		Total		2,480	

	(₹in Lakhs)	
Note 1. Share Capital	As at 1st April, 2013	As at 1st April, 2012

Authorised, Issued, Subscribed & paid up		
16.42 lakhs Equity Shares of ₹ 10 each [of the above shares, 42,000 Equity shares are allotted as fully paid up for consideration other than cash]	164.20	
Total	164.20	

RECONCILIATION OF SHARE CAPITAL				
FOR EQUITY SHARE :-	**As at 1st April 2013**		**As at 1st April 2012**	
	Nos	**Amount (₹)**	**Nos**	**Amount (₹)**
Opening Balance as on 01.04.12	16.00	160.00	NIL	NIL
Add: Fresh Issue (Incld, Bonus shares, Right shares, split shares, shares issued other than cash)	0.42	4.20	NIL	NIL
	16.42	164.20	NIL	NIL
Less: Buy Back of shares	-	-	-	-
	16.42	164.20	NIL	NIL

Note: It has been assumed that Current assets have been taken over by S Ltd. at their book value.

Note 2. Reserves and Surplus	As at 1st April, 2013	As at 1st April, 2012
Reserves	800.00	
Capital Reserve	126.00	
Securities Premium	37.80	
Total	963.80	
Note 3. Other Current Liabilities	As at 1st April, 2013	As at 1st April, 2012
Other Liabilities	240.00	

Current Liabilities (712+400)	1,112.00	
Total	1,352.00	
Note 4. Tangible assets	As at 1st April, 2013	As at 1st April, 2012
Particulars	Amount (₹)	Amount (₹)
Fixed asset (200+80)	280.00	
Total	280.00	
Note 5. Other Current Assets	As at 1st April, 2013	As at 1st April, 2012
Current Assets	2,200.00	
(1,600+600)		
Total	2,200.00	
Note : It has been assumed that Current assets have been taken over by S Ltd. as their book value.		

Question No. 17

The following was the balance sheet of Star Ltd. as at 31st March, 2013.

Liabilities	**₹ in lakhs**
10% Redeemable Preference Shares of ₹ 10 each, fully paid up	**10,000**
Equity Shares of ₹ 10 each fully paid up	**32,000**
Capital Redemption Reserve	**4,000**
Securities Premium	**3,200**
General Reserve	**24,000**
Profit and Loss Account	**1,200**
9% Debentures	**20,000**
Sundry creditors	**9,200**
Sundry Provisions	**4,000**
	1,07,600

Assets	**₹ in lakhs**
Fixed assets	**56,000**
Investments	**12,000**
Cash at Bank	**6,600**

Other Current assets	**33,000**
	1,07,600

On 1st April, 2013 the company redeemed all of its preference shares at a premium of 10% and bought back 25% of its equity shares @ ₹ 20 per share. In order to make cash available, the company sold all the investments for ₹ 12,600 lakh and raised a bank loan amounting to ₹8,000 lakhs on the security of the company's plant.

Pass journal entries for all the above mentioned transactions including cash transactions. The amount of securities premium has been utilized to the maximum extent allowed by law.

Answer:

Journal Entries

	Particulars	Debit	Credit
		₹ in lakhs	**₹ in lakhs**
1.	Bank A/c Dr. To Investment A/c To Profit and Loss A/c (Being sale of investments and profit thereon)	12,600	 12,000 600
2.	Bank A/c Dr. To Bank Loan A/c (Being loan taken from bank)	8,000	 8,000
3.	10% Redeemable preference Share capital A/c Dr. Premium on redemption of preference shareholder A/c Dr. To Preference shareholder A/c (Being redemption of preference shares)	10,000 1,000	 11,000
4	Preference shareholders A/c Dr. To Bank A/c (Being payment of amount due to preference shareholders)	11,000	 11,000
5.	Securities premium A/c Dr. To Premium on redemption of preference share A/c (Being use of securities premium to provide premium on redemption of preference shares)	1,000	 1,000

	Particulars	Debit	Credit
		₹ in lakhs	₹ in lakhs
6.	Equity Share capital A/c Dr.	8,000	
	Securities premium A/c [3,200 – 1,000] Dr.	2,200	
	General reserves A/c [(800×20) - 8000 – 2,200] Dr.	5,800	
	To Equity shareholders A/c		16,000
	(being buy back of equity shares)		
	Note : Balance of General Reserve [24,000 – 5,800] = ₹18,200.		
7.	General Reserves A/ c Dr.	18,000	
	To Capital Redemption Reserve A/c (8,000 + 10,000)		18,000
	(Being creation of capital redemption reserve to the extent of the face value of preference share redeemed and equity shares bought back).		
	Note: Balance in General reserve (18,200 – 18,000)		
	= ₹ 200.		
8.	Equity shareholders A/c Dr.	16,000	
	To Bank A/c		16,000
	(Being payment of amount due to equity shareholders).		
	Note : Cash at Bank [6,600+12,600+8,000-11,000-16,000] = ₹200		

Study Note 8: Liquidation of Comapny

Question No. 18

(a) What are the Procedure in Creditors' Voluntary Winding up?

Answer:

Procedure in Creditors' Voluntary Winding up:

(i) Meeting of creditors: The Company calls a meeting of its creditors. The board of directors lay before the meeting a full statement of the position of the company's affairs and a list of the creditors of the company and the estimated amount of their claim. A copy of the resolution passed at the creditors' meeting is filed with the Registrar of Companies.

(ii) Appointment of liquidator: Appointment of liquidator is made by nomination both by the members and creditors at their respective meetings. If they nominate different persons, ordinarily, the creditors' nominee shall be the liquidator. But any director, member or creditor may apply to the Tribunal for an order that the company's nominee or the official liquidator or some other person should be appointed. If no person is nominated by the creditors, the members' nominee shall be the liquidator. Likewise, if no nomination is made by the members, the creditors' nominee shall be the liquidator.

(iii) Inspection committee: (a) The creditors of the company may appoint a committee of inspection consisting of five persons; (b) Company can also in its general meeting appoint 5 members to work as members of inspection committee.

(iv) Meeting of members and creditors: If the winding up process continues for more than a year, the liquidator shall call a general meeting of members and creditors at the end of each year within three months from the expiry of such year. In the meeting, he will present an account of his acts and dealings and the progress of the winding up during the year.

(v) Final meeting: When the affairs of the company are fully wound up, an account of the winding up is prepared to show how the winding up has been conducted and the property of the company has been disposed off. The account is presented before the final meeting of members. Besides, a copy of the account along with a report is sent to the National Company Law Tribunal and the Registrar within one week of the meeting. The company is deemed to have been dissolved from the date of submission of the report.

(b) Moon Ltd went in for Voluntary Liquidation on 31st March. The Company's Articles provide that on liquidation, out of Surplus Assets remaining after payment of Liquidation Costs and outside Liabilities, it shall be applied firstly towards arrears of Preference Dividend, secondly to Preference Shareholders with a premium thereon at ₹ 10 Per Share and finally any residue shall be paid to the Equity Shareholders.

The Balance Sheet of the Company as at 31st March is given below –

Equity & Liabilities	₹	Assets	₹
Equity Share Capital	10,00,000	Freehold Property	11,85,000
(1,00,000 Shares of ₹ 10 Each)	12,00,000	Plant	6,03,000
10% Preference Share Capital	1,00,000	Motor Vehicles	1,15,000
(₹ 100 each fully paid)	2,00,000	Stock	3,72,000
Securities Premium	5,000	Sundry Debtors	1,48,000
5% Debentures	1,16,000	Profit and Loss A/c	4,28,000
Interest on Debentures	2,30,000		
Bank Overdraft			
Sundry Creditors			
Total	28,51,000	Total	28,51,000

Preference Dividends are in arrears for past two years. The Liquidator realised the Assets as below -

Particulars	₹	Particulars	₹
Freehold Property	14,25,000	Stock in Trade	3,00,000
Plant	5,05,000	Sundry Debtors	1,20,000
Motor Vehicles	1,18,000		

Creditors were paid less Discount of 5% Debentures with accrued interest upto 30th June (3 months after above Balance Sheet date) was paid. Liquidators Remuneration is 2% of the Assets realised. Cost of Liquidation was ₹ 7,640. Prepare the Liquidators' Statement of Account.

Answer:

Liquidator's Final Statement of Account

Receipts	₹	Payments	₹
Assets realized:	1,20,000	Liquidators Remuneration (24,68,000 x 2%)	49,360
- Debtors	3,00,000	Liquidation Cost	7,640
- Stock	14,25,000	Debentureholders having a floating Charge:	
- Freehold Property	5,05,000	- Principal 2,00,000	
- Plant and Machinery	1,18,000	- Interest upto 30th June (5,000+2,500) 7,500	2,07,500
- Motor Vehicles		Unsecured Creditors:	
		- Trade Creditors (2,30,000-5% Discount) 2,18,500	
		- Bank Overdraft 1,16,000	3,34,500
		Preference Shareholders:	
		- Arrears of Dividend	
		(12,00,000 x 10% x 2 Yrs) 2,40,000	
		- Share Cap. + Redemption	
		Premium ₹ 10/Share 13,20,000	15,60,000
		Equity Shareholders (balancing figure)	
		(1,00,000 Equity Shares at ₹ 3.09 per Share)	3,09,000
Total	24,68,000	Total	24,68,000

Note: It is assumed that arrears of Preference Dividend of 2 years is inclusive of the year ending on 31st Mar above.

Study Note 9 : Auditing Concepts

Question No. 19

(a) Where the accounts of the company do not present a 'true and fair ' view, the auditor of the company can give a qualified opinion.

Answer:

The statement is false. An adverse opinion is appropriate where the reservations or the objections are so substantial that the auditor feels, that the accounts do not give a 'True and Fair' view. Qualified opinion would imply that the financial statement project a 'True and Fair' view subject to certain reservations.

(b) Distinguish between Principles & Techniques of Auditing.

Answer:

Principles of Auditing	Techniques of Auditing
It refers to the fundamental considerations that sustain the function of auditing and direct its activities.	It refers to the methods and means adopted by the Auditor for collection and evaluation of audit evidence in different auditing situations.

As listed in SA - 200, these are - (a) Integrity, Objectivity & Independence, (b) Confidentiality, (c) Skills and Competence, (d) Work performed by others, (e) Documentation, (f) Planning, (g) Audit Evidence, (h) Accounting System & Internal Control, (i) Audit Conclusions and Reporting.	These are not listed exhaustively. Some examples are - (a) Physical Inspection (of Fixed Assets), (b) Confirmation (of Debtors Balances), (c) Inquiry (on Accounting Systems), (d) Calculation of Ratios (GP Ratio, NP Ratio).
The principles are not liable to change frequently.	Audit techniques may vary according to the nature of propositions to be tested.
They do not vary with time.	The techniques to be adopted vary with the time / period of auditing.
Principles of auditing remain the same irrespective of the nature of the Firm.	They may vary from Firm to Firm depending upon the nature of business, number of transactions, etc.

Study Note 10: Provisions Relating to Audit under Companies Act

Question No. 20

(a) Discuss the qualities a management auditor should possess.

Answer:

The management auditor should possess the following qualities:

i) Ability to understand the nature and objectives and problems faced by the organisation.

ii) He should have general understanding of different laws and regulations like Tax Laws, Company Laws etc.

iii) Expert knowledge of management principles such as delegation of authority, management by exception, budgetary control, flow charts, etc.

iv) Sufficient knowledge and experience in preparing and presenting reports to different levels of management.

v) Working knowledge of engineering, costing, statistics, management accounting, industrial psychology etc.

vi) Dynamic, tactfulness and a pleasing personality.

(b) Discuss how Cost Audit is useful to Management, society, Shareholders and Government?

Answer:

The major advantage of Cost Audit, to various categories of persons, is as under –

1. To Management:
   (a) Reliability of date for day-to-day operations like determination of price, cost control, decision making etc.
   (b) Continuous check on all wastages through a proper system of reporting.
   (c) Highlighting of inefficiencies in operations, in order to take corrective action.
   (d) Adoption of management by Exception through allocation of responsibilities to individual managers.
   (e) Introduction of a system of Budgetary Control and Standard Costing.
   (f) Establishment of reliable check on the valuation of Closing Stock and Work-in-Progress.
   (g) Detection and prevention of errors and fraud.
2. To the Society:
   (a) Proper pricing on the basis of correct costing data saves consumer from exploitation.
   (b) Consumers can maintain their standard of living, since price increase by the industry is not allowed without proper justification like, increase in cost of materials, labour, etc.
3. To Shareholders: Cost Audit benefits the shareholders by ensuring that –
   (a) Proper records are kept for purchases, utilization of materials, expenses incurred on wages, OH, etc.
   (b) The enterprise has been run economically and efficiently.
   (c) A fair return on investment is determined by proper determination of costs.
4. To The Government:
   (a) To fix the price of cost-plus contracts, wherever applicable.
   (b) To fix selling price of essential commodities and therefore check undue profiteering.
   (c) To focus its attention on inefficient units.
   (d) To decide on granting of protection to certain industries based on their needs.
   (e) To settle trade disputes brought to the Government.
   (f) To impose automatic check on inflation by promoting healthy competition among industries.

(c) Discuss the process of Audit in Depth.

The process of examination in depth explains its meaning and importance. It is stated as under:
i. Fixation of the maximum tolerable error limit/desired confidence level.
ii. Selecting a few transactions in each area of audit to be checked.
iii. Verification of those selected transactions- 100% by verifying the accounting aspects, internal control aspects, documentation and audit trail.
iv. Audit trail refers to the documents, records, books and files, which enable an auditor to trace a transaction from its source till it is summed up, recorded and presented in an accounting report.
v. Analysis of the results with the maximum tolerable error limit.

Study Note 11 : Audit Planning , Programme and Procedure

Question No. 21

Draft the audit programme for audit of receipt of participation fees from delegates to the National Cost Convention.

Answer:

The organization of three-day National Cost Convention is a one-time event. Normally, in view of mega-size of the event, a special cell is made in the organization to handle the entire event. Since few people would be handling the event, the internal controls may not be that strong and, thus, more emphasis is required to be given on substantive procedure. Audit of receipt of participation fees should be under the following areas:

(I) Internal Control System

- Examine the organization structure of special cell created for the National Cost Convention, if any, and division of responsibilities amongst persons and control/custody over receipt books.
- Verify the internal control system for restricting the participation of unregistered **delegates.**

(II) Rate of Participation Fees

- Verify with reference to resolution passed by the Organizing Committee
- Also verify the rate from the literature/registration form circulated for promotion of conference.

(III) Receipts of Participation Fees

- Verify counter foil of the receipts issued for individual registration.
- Ensure that receipts are issued for all the registration received in cash.
- Trace the receipts in Bank Statement or Cash Book – as the case may be.
- Verify Bank Reconciliation Statement and list out dishonored cheques.
- Verify subsequent recovery in respect of dishonored cheques.

(IV) Overall Checking

- Verify the total receipts of participation fees shown in the financial statements with reference to total number of receipts issued to participants.
- Cross check the total number of delegates with reference to the following:
  - Kits distributed to participants.
  - Bill of caterer for providing meals during conference.
  - Capacity of the Hall.
  - Participation Certificate if any issued.

(V) Foreign Delegates: In case of foreign delegates – if registration fees are higher – ensure that they are registered at higher fees.

(VI) Special Issues

- Take out list of absentees and in case of nil absentees, probe the issue further.
- (ii) If certain participants are exempted from payment of fees – obtain the list along with proper authorization in this regard.

Study Note 12: Internal Control, Internal Check and Internal Audit

Question No. 22

(a) The Cost Auditor of a company cannot function as an internal auditor of the same company.

Answer:

The statement is true. The Cost Auditor is required to comment on the scope and performance of the internal audit as per the provisions of the Cost Audit (Report) Rules, 2011. If the Cost Auditor also functions as internal auditor, he will not be able to discharge his duties in proper and dispassionate manner.

(b) Elaborate the principles of internal check system that should be followed with regard to cash payments.

Answer:

The principles to be followed are enumerated below:

- Making all payments through cheques except petty cash payments.
- Segregating duties: The employee in charge of receipts should not be involved in making payments.
- All payments should be duly authorized.
- The unused cheques should be under proper custody.
- The vouchers supporting payments should be stamped as 'paid' so that they are not presented twice.
- Statement of dues received from creditors should be verified with invoices and ledger accounts before authorizing payments. Confirmation of accounts should be made with creditors.
- Monthly or periodic payments should be always be made on fixed dates.
- Bank reconciliation statements should be made at least monthly to locate the difference between cash and bank book if any. The statement should be prepared by an independent person not in charge of receipts or payments.

(c) How would you audit 'Inventory Control and Management' as an Internal Auditor?

Answer:

The Internal Auditor should ensure the following as regards 'Inventory Control and Management':

(i) Has the inventory been classified for proper control? Is A, B, C system of inventory classification followed?

(ii) How the inventory levels – maximum, minimum, reorder, economic order quantity fixed?

(iii) Is material budget prepared in advance to regulate purchase?

(iv) Study the opening/closing stocks of the last few years.

(v) Study the procurement of materials for the last 2/3 years and see whether the same compares favourably with production.

(vi) Is there any regular system to assess slow-moving/non-moving stores items for early disposal in cases considered necessary?

(vii) Who is the person to declare some material as surplus? Who authorizes its disposal?

(viii) Review whether value analysis, PERT etc. are applied for better management of stores.

(ix) Work out inventory ratios to judge the reasonableness of inventory build up

(a) working capital to store inventory

(b) Current assets to store inventory

(c) Inventory turnover.

Some General Aspects:-

(i) Sometimes used materials are returned to stores. In such cases procedure for recording would be the same as followed in case of unused materials except that these may or may not be priced. Usually separate stores ledger / bin cards are opened. See whether the procedure in this regard has been observed.

(ii) Review whether any study has been made in regard to mechanization in stores receipt/issue, store accounting.

(iii) Review whether proper numerical accounts have been kept in respect to stand by spares.

(iv) See whether there is any Material Receiving Report pending disposal – recording valuation in stores ledger/bin card, accounting the accounts records etc.

(v) Review the mode of valuation of closing stock.

(vi) How soon the stores schedule is prepared for annual accounts purpose?

(vii) Are the stores materials adequately covered by insurance against loss from fire and other risks?

(viii) Is there proper coordination between –

(a) Central Purchase Department

(b) Local Purchase Department

(c) Stores Department

(d) Stock – verification Department

(ix) In case there are number of factories producing same / similar products make comparative study regarding –

(a) Surplus materials

(b) Obsolete/slow-moving materials.

(c) Finished/work-in-progress stock

(d) Opening/closing stock of raw material, etc.

Apart from the above O and M study may be carried out for standardization of forms, modification of work flow for improvement in efficiency in various directions etc.

(d) Write short notes on Independence of Internal Auditor.

Answer:

Purpose: Internal Auditing is an independent appraisal function, established within an organization to examine and evaluate its activities as service to the organization. The Internal Auditor is appointed by the entity for this purpose.

Status: The Internal Audit Department should have an independent status in the organization. The Internal Auditor must have sufficiently high status in the organisation. He may be required to report directly to the Board of Directors.

Appointment: The Management of the entity appoints the Internal Auditor.

Scope of Work: The Management of an entity fixes the scope of the Internal Auditor and it ranges from the pure review of accounting functions to the review of various operational services in the organization.

Orientation: Internal audit is voluntary and is authorized by the Management for and on behalf of management and hence it is essentially management oriented.

It can be concluded from the above that the degree of independence of Internal Auditor is less when compared to that of the independence enjoyed by the External (Statutory) Auditor. Hence, the External Auditor is required to assess the work of the Internal Auditor before relying on the same.

Study Note 13: Vouching and Verification

Question No. 23

(a) The scope of verification is much wider than that of vouching.

Answer:

The statement is true. Vouching enables the auditor to know whether the transactions are genuine and valid to enable the auditor to report on the financial statements with reference to relevant documentary evidence. Vouching is the substantive testing/examination of transaction at their *point of origin*. On other hand, verification process encompasses the inquiry into the ownership/ title, existence, valuation, completeness and presentation of assets and liabilities in the balance sheet. Verification usually deals with the *final balance* in the Final Accounts viz the balance sheet and profit and loss account.

(b) What are the assertions with which an auditor is concerned with while obtaining audit evidence from substantive procedures?

Answer:

An auditor is concerned with following assertions:-

(i) Existence:That an asset or liability exists at a given date.

(ii) Rights and obligations: That an asset is a right of the concern and a liability is an obligation at a given date.

(iii) Occurrence: That a transaction or event which took place pertains to the entity during the relevant period.

(iv) Completeness: That there are no unrecorded assets, liabilities or transaction.

(v) Valuation: That an asset or liability is recorded at an appropriate carrying value.

(vi) Measurement: That a transaction is recorded in the proper amount and revenue or expense is allocated to the proper period.

(vii) Presentation and disclosure hat an item is disclosed classified and described in accordance with recognized accounting policies and practices and relevant statutory requirements.

(c) Auditors of M/s FBG (P) Ltd. were changed for the accounting year 2012-13. The closing stock of the company as on 31.3.2013 amounting to ₹ 350 lacs continued as it is and became closing stock as on 31.3.2014. The auditors of the company proposed to exclude from their audit programme the audit of closing stock of ₹ 350 lacs on the understanding that it pertains to the preceding year which was audited by another auditor. Give your comments.

Answer:

According to SA 510 "Initial Engagements – Opening Balances", requires that for initial audit engagements, the auditor should obtain sufficient appropriate audit evidence that:

(a) the closing balances of the preceding period have been correctly brought forward to the current period;

(b) the opening balances do not contain misstatements that materially affect the financial statements for the current period; and

(c) appropriate accounting policies are consistently applied.

When the financial statements for the preceding period were audited by another auditor, the current auditor may be able to obtain sufficient appropriate audit evidence regarding opening balances by perusing the copies of the audited financial statements. Ordinarily, the current auditor can place reliance on the closing balances contained in the financial statements for the preceding period, except when during the performance of audit procedures for the current period the possibility of misstatements in opening balances is indicated.

General principles governing verification of assets require that the auditor should confirm that assets have been correctly valued as on the balance sheet date. The contention of the management that the stock has not undergone any change cannot be accepted, it forms part of normal duties of auditor to ensure that the figures on which he is expressing opinion are correct and properly valued. Moreover, it is also quite likely that the stock lying as it is might have deteriorated and the same need to be examined. The auditor is advised not to exclude from his audit programme the audit of closing stock.

Question No. 24

(a) No depreciation has been charged for the year ended 31st March 2014, in respect of a spare car purchased during the year and kept ready by the company for use as a stand-by on the ground that it was not used during the year. State your views as an auditor.

Answer:

As per AS 6 on "Depreciation Accounting", depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes. Thus, depreciation has to be charged even in case of these assets which are not used at all during the year but by mere effluxion of time provided such assets qualify as depreciable assets. When the spare car was kept ready for use as stand-by, it means it was intended to be used for the purpose of business. Depreciation in respect of this bus ought to have been provided in the accounts for the year ended 31st March, 2014. If there is an intention to use an asset, though it may not have actually been used, it is a 'constructive' or 'passive' use and eligible for claim of depreciation.

(b) Fixed assets have been revalued by PL Ltd. and the resulting surplus has been adjusted against the brought forward losses. What is your opinion as an auditor?

Answer:

The revaluation of fixed assets is a normally accepted practice which involves writing up the book value of fixed assets. AS 10 on ‘Accounting for Fixed Assets’ requires that “an increase in net book value arising on revaluation of fixed assets is normally credited directly to owner’s interests under the heading of revaluation reserves and is regarded as not available for distribution”. Thus, creation of revaluation reserves does not result into any cash inflows and represents unrealised gains. However, brought forward losses are in the nature of revenue losses. As a matter of prudence, revenue losses can be adjusted against revenue reserves only and not the capital reserves. Therefore, the accounting treatment followed by the entity is not correct and the auditor should qualify the audit report by mentioning the above fact.

Question No. 25

As an auditor, how will you vouch and/or verify the following?

(a) Work-in-progress

(b) Receipt of special backward area subsidy from Government:

(c) Borrowing from Banks

(d) Machinery acquired under Hire-purchase system.

Answer:

(a) Work-in-progress:

The audit procedures regarding work-in-progress are similar to those used for raw materials and finished goods. However, the auditor has to carefully assess the stage of completion of the work-in-progress for assessing the appropriateness of its valuation. For this purpose, the auditor may examine the production/costing records (i.e., cost sheets), hold discussions with the personnel concerned, and obtain expert opinion, where necessary. The auditor may advise his client that where possible the work-in-progress should be reduced to the minimum before the closing date. Cost sheets of work-in-progress should be verified as follows:

(i) Ascertain that the cost sheets are duly attested by the works engineer and works manager.

(ii) Test the correctness of the cost as disclosed by the cost records by verification of quantities and cost of materials, wages and other charges included in the cost sheets by reference to the records maintained in respect thereof.

(iii) Compare the unit cost or job cost as shown by the cost sheet with the standard cost or the estimated cost expected.

(iv) Ensure that the allocation of overhead expenses had been made on a rational basis.

Compare the cost sheet in detail with that of the previous year. If they vary materially, investigate the cause thereof.

(b) Receipt of special backward area subsidy from Government:

i. The claim for backward area subsidy submitted to the authorities should be studied.

ii. It should be ascertained whether the grant is of a capital nature for funding assets or of a revenue nature. Mere computation formula of quantum of grant with reference to the cost of project of itself will not make the grant a capital nature is to facto.

iii. The accounting of grant should be in accordance with AS 12 "Accounting for Government Grants". The revenue grant can be taken to income statement, with appropriate disclosure.

iv. The capital grant may be adjusted against cost of asset or may be kept in a capital reserve to be transferred to profit and loss account each year in proportion to depreciation of that asset charged in profit and loss account.

v. The receipt of the grant should be checked with bank statement, remittance challan etc.

vi. The conditions attached to grant should be fulfilled by the company. The auditor should check whether any liability or refund of grant for breach of conditions could arise.

(c) Borrowing from Banks:

Borrowing from banks may be either in the form of overdraft limits or term loans. In each case, the borrowings should be verified as follows:

(i) Reconcile the balances in the overdraft or loan account with that shown in the pass book(s) and confirm the last mentioned balance by obtaining a certificate from the bank showing the balance in the accounts as at the end of the year.

(ii) Obtain a certificate from the bank showing particulars of securities deposited with the bank as security for the loans or of the charge created on an asset or assets of the concern and confirm that the same has been correctly disclosed and duly registered with Registrar of Companies and recorded in the Register of charges.

(iii) Verify the authority under which the loan or draft has been raised. In the case of a company, only the Board of Directors is authorised to raise a loan or borrow from a bank.

(iv) Confirm, in the case of a company, that the restraint contained in Section 293 of the Companies Act, 1956 as regards the maximum amount of loan that the company can raise has not been contravened.

Ascertain the purpose for which loan has been raised and the manner in which it has been utilised and that this has not prejudicially affected the entity

(d) Machinery acquired under Hire-purchase system.

(i) Examine the Board's Minute Book approving the purchase on hire-purchase terms.

(ii) Examine the hire-purchase agreement carefully and note the description of the machinery, cost of the machinery, hire purchase charges, terms of payment and rate of purchase.

(iii) Ascertain that the machinery has been included in the related assets account at its cash value. Also instalments due have been paid and the hire-purchase charges applicable to the period from the commencement of the agreement to the end of the financial year have been charged against current profits.

(iv) Ensure that machinery acquired on hire purchase basis has been included at its cash value in the balance sheet and depreciation has been calculated on the cash value from the date of the purchase. The amount due to the hire purchase company in respect of the capital outstanding has either been shown as a deduction from the machinery account or as a separate amount under current liabilities.

Study Note 14 : Audit of Regulated and Non- Regulated Industries

Question No. 26

(a) The HIJ College, an institution managed by WB Trust, has received a grant of ₹ 5 crore from Government nodal agencies for funding a project of research on rural health systems in India. Draft an audit programme for auditing this fund in the accounts of the college.

Answer:

Audit of grant fund of a college:

(i) The auditor should obtain the basic documents about the constitution of the college, objectives of the trust, rules of college etc.

(ii) The government policy on grant should be checked with the relevant application, brochure, and sanction advices.

(iii) The conditions stipulated in award of grant should be studied.

(iv) The receipt of grant should be vouched with bank statement.

(v) The budgeted heads of expenses for the project and actual utilization of the fund should be checked.

(vi) The purchase of capital items covered within the project should be correctly capitalized. The same should be properly and distinctly shown in the balance sheet of the college. The cost of the asset should be adjusted for the grant amount.

(vii) The expenses of revenue nature incurred from and out of grant in the form of salaries to field staff, materials purchased, traveling, survey and field work expenses and analysis and preparation of reports etc should be vouched with the relevant vouchers.

(viii) The expenses should be accounted as withdrawal of amounts from the fund. It is to be checked that these expenses are not accounted in income and expenditure of the college.

(ix) In balance sheet, the fund account should be shown as a liability with a separate schedule indicating the receipts, payments and balance as on the date of closing of accounts.

(x) The fund balance should be cross checked with the periodical statements of accounts submitted to the nodal agencies.

(xi) The physical verification of assets pertaining to the project should be done by the management of the college.

(xii) The progress of the project may be ascertained from the minutes, committee meeting extracts and reports. This must be done to ensure that the project fund is genuinely utilized for the purposes it intended for.

(b) What are the main points involved in 'Performance Audit' under Government Accounting system?

Answer:

Performance audit refers to an examination of a program, function, operation or the management systems and procedures of a governmental or non-profit entity to assess whether the entity is achieving economy, efficiency and effectiveness in the employment of available resources. The examination is objective and systematic, generally using structured and professionally adopted methodologies.

The scope of audit has been extended to cover efficient, economy and effectiveness audit or performance audit.

Efficiency audit look into whether various schemes/projects are executed and their operations conducts economically & see that amount spent gives expected result & projects carried out in an economical manner.

Economy aspect looks whether government has acquired financial, human and physical resources in an economical manner and that sanctioning and spending authority have observed economy.

Effectiveness looks into appraisal of performance of programmes, schemes, projects with overall targeted objectives.

Efficiency cum performance audit is examination of Financial & operational aspect of performance.

The performance audit involves preliminary study, planning & execution of audit & reporting.

(c) Discuss the areas to be covered by an auditor during his course of audit of a Partnership Firm.

Answer:

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:

(i) 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.
(ii) 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.
(iii) 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.
(iv) 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.

(v) Examining whether books of account appear to be reasonable and are considered adequate in relation to the nature of the business of the partnership.
(vi) 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.
(vii) 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.
(viii) Verifying that the profits and losses have been divided among the partners in their agreed profit-sharing ratio.

Study Note 15 : The Company Auditor

Question No. 27

(a) Comment on the following situations:

At an Annual General Meeting, Mr. B a retiring auditor claims that he has been reappointed automatically, as the intended resolution of which a notice had been given to appoint Mr. A, could not be proceeded with, due to Mr. A's death.

Answer:

Section 224(2) of the Companies Act, 1956 dealing with reappointment of auditors specifies that subject to the provisions of sub-section (1B) and section 224A, at any Annual General Meeting a retiring auditor, by whatsoever authority appointed, shall be re-appointed unless, *inter alia*:

"Where notice has been given of an intended resolution to appoint some person or persons in the place of a retiring auditor, and by reason of the death, incapacity or dis-qualification of that person or of all those persons, as the case may be, the resolution cannot be proceeded with."

However, it should be noted that even for the re-appointment of a retiring auditor, the passing of a resolution is essential. Section 224 of the Companies Act, 1956, requires that a resolution has to be passed by the company every year. In the absence of a resolution, the retiring auditor is not re-appointed automatically.

Thus, the claim of Mr. B would not hold good.

(b) PQR Limited with its registered office at Bangalore has two branch offices located at Mumbai and Kolkata. The accounting transactions of the branches are recorded and the accounting records are maintained in the branches themselves. Only quarterly summarized Trial balance, Profit and Loss account and Balance Sheet are sent to Bangalore office by the branch Accountants. Do you think that the Company is at fault of not maintaining proper books at registered office as per the Company law provisions?

Answer:

According to Section 227 of the Companies Act, 1956, the auditor has to report whether the company has maintained proper books of account. According to section 209 of the Companies Act, the company has to keep at its registered office all the accounting records specified therein.

As regards, the records of the branch, Section 209 permits that the same may be maintained at branches provided summarized returns of the branch are sent to registered office at such frequent intervals not less than a quarter.

In the present case, since the branches are sending quarterly summarized returns of accounting details, it is deemed that proper books of accounts are maintained at registered office.

Hence, there is no statutory violation committed by the company.

It may be noted, still the company auditor has right of access (at registered office itself by calling for records) and right to visit the branch.

Study Note 16: The Company Audit

Question No. 28

Discuss the areas to be covered by an auditor while splitting the shares of face value from ₹ 10 to ₹ 2 per share of a company.

Answer:

- 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 also with reference to Form filed with the ROC.
- 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.

Study Note 17: Audit Report

Question No. 29

(a) According to Sec 227(1) of the Companies Act, 1956, the auditor can call for *any* explanations or information from the officers and employees of the company.

Answer:

The statement is false. According to the Companies Act, 1956 the auditor can call for explanations or information which he thinks is relevant for the purpose of audit and proper discharge of his duties.

(b) The members of XYZ Ltd. preferred a complaint against the auditor stating that he has failed to send the auditor's report to them.

Answer:

Section 227 of the Companies Act, 1956 lays down the powers and duties of auditor. As per provisions of the law, it is no part of the auditor's duty to send a copy of his report to members of the company. The auditor's duty concludes once he forwards his report to the company. It is the responsibility of company to send the report to every member of the company. It will be for the secretary or the director to convene a general meeting and send the balance sheet and report to the members (or other person) entitled to receive it. Hence in the given case, the auditor cannot be held liable for the failure to send the report to the shareholders.

Study Note 18: Standards on Auditing (SA)

Question No. 30

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

Answer:

Following are the objectives and functions of Auditing and Assurance Standard Board (AASB):

- To review the existing and emerging auditing practices worldwide and to formulate Engagement Standards, Standards on Quality Control and Statement on Auditing.
- To review and revise the existing Standards and Statements on Auditing.
- To develop Guidance Notes on issues arising out of any Standard, auditing issues pertaining to any specific industry and revise.
- To review and revise the existing Guidance Notes.
- To formulate General Clarifications, where necessary, on issues arising from Standards.
- To formulate and issue Technical Guides, Practice Manuals, Studies and other papers.

(b) Describe the audit procedures necessary in order to gain sufficient audit evidence to be able to form an opinion on the going concern status of a company?

Answer:

Based on the audit evidence obtained, the auditor shall conclude whether, in the auditor's judgment, a material uncertainty exists related to events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern. A material uncertainty exists when the magnitude of its potential impact and likelihood of occurrence is such that, in the auditor's judgment, appropriate disclosure of the nature and implications of the uncertainty is necessary for:

(i) In the case of a fair presentation financial reporting framework, the fair presentation of the financial statements, or

(ii) In the case of a compliance framework, the financial statements not to be misleading.

When the auditor concludes that the use of the going concern assumption is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether the financial statements:

(i) Adequately describe the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions; and

(ii) Disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it may be unable to realise its assets and discharge its liabilities in the normal course of business.

If adequate disclosure is made in the financial statements, the auditor shall express an unmodified opinion and include an Emphasis of Matter paragraph in the auditor's report to:

(i) Highlight the existence of a material uncertainty relating to the event or condition that may cast significant doubt on the entity's ability to continue as a going concern; and to

(ii) Draw attention to the note in the financial statements.

If adequate disclosure is not made in the financial statements, the auditor shall express a qualified or adverse opinion, as appropriate. The auditor shall state in the auditor's report that there is a material uncertainty that may cast significant doubt about the entity's ability to continue as a going concern.