# Paper 12 - Company Accounts & Audit

**Full Marks: 100**

# Section A

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

**(i) Differentiate between Reporting Currency and Foreign Currency.**

**Answer:**

Difference between Reporting Currency and Foreign Currency

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

**(ii) Define Financial Assets and Financial Liability as per AS 20.**

**Answer:**

Financial Asset: A Financial Asset is any asset that is –
(a) Cash
(b) A contractual right to receive cash or another Financial Asset from another Enterprise,
(c) A contractual right to exchange Financial Instruments with another Enterprise, under conditions that are potentially favorable, or
(d) An Equity Share of another Enterprise.

Financial Liability: A Financial Liability is any liability that is a contractual obligation –
(a) To deliver cash or another Asset to another Enterprise, or
(b) To exchange Financial Instruments with another Enterprise, under conditions that are potentially unfavourable.

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

**(a) Explain the objective of Financial Statements. [8]**

**Answer:**

Objective of Financial Statements

The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions. This would guide in deciding statements, their contents and disclosures.

A set of general purpose financial statements focus on financial position, performance and cash flows of an entity which could be used by any user group to assess investment decision,

employment stability or growth, debt servicing, business continuity and ability to make societal contribution. General purpose financial statements are those intended to meet the needs of users who are not in a position to require an entity to prepare reports tailored to their particular information needs.

A complete set of financial statements as worked out in Para 10 of IAS 1 is the outcome of the Framework which in turn is linked to subserve the information need of various user-groups. It comprises of:

(i) a statement of financial position as at the end of the period;

(ii) a statement of comprehensive income for the period ;

(iii) a statement of changes in equity for the period;

(iv) a statement of cash flows for the period;

(v) notes, comprising a summary of significant accounting policies and other explanatory information; and

(vi) a statement of financial position as at the beginning of the earliest comparative period when an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements.

Notes, comprising a summary of significant accounting policies and other explanatory information are important components of financial statements as they explain various elements of financial statements. Disclosure of risks adds to the information content of the financial statements.

Earning per share information contained in the Income Statement is focused information to shareholders as regards entity's performance. Information regarding diluted earning improves the information communique working out the effect of possible equity dilution actions. Similarly, segment reporting is intended to provide disaggregated information based on operating and / or geographic segments, consolidated financial statements focus on providing aggregated financial information for the entity-group as a whole, related party disclosures are intended to highlight non-market oriented transactions, if any. Thus the origination and improvement in disclosure and presentation standards have the purpose of making a set of general purpose financial statements useful to the diverse user-groups.

**(b) (i) Compute Basic Earnings Per Share from the following information –**

| Date | Particulars | No. of Shares |
|---|---|---|
| **1st April 2011** | **Balance at the beginning of the year** | **1,500** |
| **1st August 2011** | **Issue of Shares for Cash** | **600** |
| **31st March 2012** | **Buy back of Shares** | **500** |

**Net Profit for year ended 31st March 2012 was `2,75,000.** **[4]**

**Answer:**

1. Computation of Weighted Average Number of Shares outstanding during the period

| Date | No. of Equity share | Period Outstanding | Time Weighting factor | Weighted Avg. No. of Shares |
|---|---|---|---|---|
| (1) | (2) | (3) | (4) | (5)= (2) x (4) |
| 1st April 2011 | (Opening) 1,500 | 12 months | 12/12 | 1,500 |
| 1st August 2011 | (Fresh Issue) 600 | 8 months | 8/12 | 400 |
| 31st March 2012 | (Buy Back) 500 | 0 Months | 0/12 | - |

| | |
|---|---|
| Weighted average Number of Equity Shares Outstanding during the period | 1,900 |

2. Basic EPS = $\dfrac{\text{Net Profit or Loss attributable to Equity Shareholders}}{\text{Weighted Average Number of Equity shares Outstanding}}$

$= \dfrac{\grave{}\ 2,75,000}{1,900 \text{ Shares}} = \grave{}144.74$ per Share.

**(ii) Discuss the accounting treatment for Operating Leases in the Financial statements of Lessor. [4]**

**Answer:**

(a) Asset Recognition: The Lessor should present an Asset given under Operating Lease in its Balance Sheet under Fixed Assets.
(b) Income Recognition: Lease Income (excluding receipts for services provided, e.g. insurance and maintenance), should be recognised in the Statement of Profit and Loss on a Straight Line Basis over the Lease Term, even if it is not received on that basis, unless another systematic basis is more representative of the time pattern in which benefit derived from the use of the leased asset is diminished.
(c) Cost Recognition: Costs, including Depreciation, incurred in earning the Lease Income are recognised as an Expense.
(d) Initial Direct Costs: Initial Direct Costs incurred specifically to earn revenues are either - (a) deferred and allocated to income over the lease term in proportion [redacted] Rent Income, or (b) are recognised as an Expense in the Statement [redacted] period in which they are incurred.
(e) Depreciation: Depreciation of Leased Assets should be on a basis consistent with the normal depreciation policy of the Lessor for similar assets. The Depreciation charge should be calculated on the basis set out in AS - 6.
(f) Impairment Losses: The Lessor should apply AS - 28 to determine whether a Leased Asset has become impaired, and treat such impairment accordingly.
(g) Selling Profit: A Manufacturer or Dealer Lessor does not recognise any Selling Profit on entering into an Operating Lease, because it is not the equivalent of a sale.

**(c) Write short notes on recognition of Past Service Cost. [8]**

**Answer:**

1. Recognition as Expense:
   (a) In measuring its Defined Benefit Liability under Para 55, an Enterprise should recognise Past Service Cost as an expense, on a straight-line basis over the average period until the benefits become vested.
   (b) To the extent that the benefits are already vested immediately following the introduction of, or changes to, a Defined Benefit Plan, an enterprise should recognise Past Service Cost immediately.

   Example:

   An Enterprise operates a pension plan that provides a pension of 2% of final salary for each year of service. The benefits become vested after 5 years of service. On 1st January 20X4, the Enterprise improves the pension to 2.5% of final salary for each year of service starting from 1st January 20X0.

   Suppose, at the date of the improvement, the PV of the additional benefits for service from 1st Jan 20X0 to 1st January 20X4 is as follows -

| | |
|---|---|
| Employees with more than 5 years' service at 01.01.20X4 | `150 |
| Employees with less than 5 years' service at 01.01.20X4 | `120 |
| (Average period until vesting: 3 years) | |
| | `270 |

In this case, the Enterprise should recognise `150 immediately because those benefits are already vested. The Enterprise should recognise `120 on a straight-line basis over 3 years from 1st January 20X4.

2. Amendment of Amortisation Schedule: An Enterprise establishes the amortisation schedule for Past Service Cost when the benefits are introduced or changed. It would be impracticable to maintain the detailed records needed to identify and implement subsequent changes in that amortisation schedule. Also, the effect is likely to be material only where there is a curtailment or settlement. So, an Enterprise should amend the amortisation schedule for Past Service Cost, only if there is a curtailment or settlement.
3. Negative Past Service Cost: Where an Enterprise reduces benefits payable under an existing Defined Benefit Plan, the resulting reduction in the Defined Benefit Liability is recognised as (negative) Past Service Cost over the average period, until the reduced portion of the benefits becomes vested.
4. Net Change: Where an Enterprise reduces certain benefits payable under an existing Defined Benefit Plan and, at the same time, increases other benefits payable under the plan for the same employees, the Enterprise treats the change as a single net change.

# Section B

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

**(i) Explain the disclosure requirement of Deferred tax assets.**

**Answer:**

Deferred Tax Asset - Disclosure requirement

To be shown as a separate line item on the face of Balance Sheet.

**(ii) Explain the disclosure requirement of Intangible assets under development.**

**Answer:**

Intangible Assets under Development - Disclosure requirement

To be shown as a separate line item on the face of Balance Sheet.

Note - Intangible Assets under development should be disclosed under this head provided they can be recognized based on the criteria laid down in AS-26.

**(iii) What is meant by List B of Contributories?**

**Answer:**

a) Persons: Shareholders who had transferred Partly Paid Shares (otherwise than by operation of law or by death) within one year, prior to the date of winding up may be called upon to pay an

amount to pay off such Creditors as existed on the date of transfer of shares. These Transferors are called as B List Contributories.

b) Liability: Their liability is restricted to the amount not called up when the shares were transferred. They cannot be called upon to pay more than the entire face value of the share. For example, if Shares having Face Value of `100 were paid up `60, the B List Contributory can be called up to pay a maximum of `40 only.

c) Conditions: Liability of B List Contributories will crystallize only (a) when the existing assets available with the liquidator are not sufficient to cover the liabilities; (b) when the existing shareholders fail to pay the amount due on the shares to the Liquidator.

**(iv) What are the disclosure requirements of reportable segment under AS 17?**

**Answer:**

An enterprise should disclose the following for each reportable segment:

(a) segment revenue, classified into segment revenue from sales to external customers and segment revenue from transactions with other segments;
(b) segment result;
(c) total carrying amount of segment assets;
(d) total amount of segment liabilities;
(e) total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (tangible and intangible fixed assets);
(f) total amount of expense included in the segment result for depreciation and amortisation in respect of segment assets for the period; and
(g) total amount of significant non-cash expenses, other than depreciation and amortisation in respect of segment assets, that were included in segment expense and, therefore, deducted in measuring segment result.

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

**(a) On 1st April 2009, Gravity Ltd. issued 442, 10% Debentures of ` 1000 each at a discount of 10% redeemable at a premium of 5% after 4 years. It was decided to create a Sinking Fund for the purposes of accumulating sufficient funds to redeem the Debentures and to invest in some radily convertible securities yielding 10% interest p.a. Reference to the table shows that `1.00 p.a. at 10% compound interest amounts to `4.641 in 4 years. Investments are to be made in the Bonds of `1000 each available at par.**

**On 31st March 2013, the investments realised `3,40,000 and debentures were redeemed. The bank balance as on that date was `50,000.**

**Required: Prepare Debenture Redemption Fund Account and Debenture Redemption Fund Investments Account for 4 years. [16]**

**Answer:**

DRF = Debenture Redemption Fund, DRFI = Debenture Redemption Fund Investment

Dr. Discount on Issue of Debentures Account Cr.

| Date | Particulars | ` | Date | Particulars | ` |
|---|---|---|---|---|---|
| 31.03.10 | To Balance c/d | 1,00,000 | 31.03.10 | By P & L App. A/c | 1,00,000 |
| 31.03.11 | To Balance c/d | 2,10,000 | 01.04.10 | By Balance b/d | 1,00,000 |
| | | | 31.03.11 | By Interest on DRFI A/c | 10,000 |
| | | | | By P & L App. A/c | 1,00,000 |
| | | 2,10,000 | | | 2,10,000 |
| 31.03.12 | To Balance c/d | 3,31,000 | 01.04.11 | By Balance b/d | 2,10,000 |
| | | | | By Interest on DRFI A/c | 21,000 |
| | | | | By P & L App. A/c | 1,00,000 |
| | | 3,31,000 | | | 3,31,000 |
| 31.03.13 | To Loss on issue of Debentures (premium) | 22,100 | 01.04.12 | By Balance b/d | 3,31,000 |
| | | | | By Interest on DRFI A/c | 33,100 |
| | To Debenture Redemption Reserve A/c | 4,52,000 | | By P & L App. A/c | 91,000 |
| | | | | By Debenture [redacted] Investment A/c [redacted] | |
| | | 4,74,100 | | | 4,74,100 |

Dr. Debentures Redemption Fund Investment (DRFI) Account Cr.

| Date | Particulars | ` | Date | Particulars | ` |
|---|---|---|---|---|---|
| 31.03.10 | To Bank A/c | 1,00,000 | 31.03.10 | By Balance c/d | 1,00,000 |
| 01.04.10 | To Balance b/d | 1,00,000 | 31.03.11 | By Balance c/d | 2,10,000 |
| 31.03.11 | To Bank A/c | 1,10,000 | | | |
| | | 2,10,000 | | | 2,10,000 |
| 01.04.11 | To Balance b/d | 2,10,000 | 31.03.12 | By Balance c/d | 3,31,000 |
| 31.03.12 | To Bank A/c | 1,21,000 | | | |
| | | 3,31,000 | | | 3,31,000 |
| 01.04.12 | To Balance b/d | 3,31,000 | 31.03.13 | By Bank A/c (Sales) | 3,50,000 |
| 31.03.13 | To Debenture Redemption Fund A/c (Profit) | 9,000 | | | |
| | | 3,50,000 | | | 3,50,000 |

**Working Note:**

(i) Calculation of the amount of profit set aside

| | | ` |
|---|---|---|
| a. | Face Value of Debentures | 4,42,000 |

| | | |
|---|---|---|
| b. | Premium Payable on Redemption | 22,100 |
| c. | Depreciable Cost (A + B) | 4,64,100 |
| d. | Value of annuity per `1 | 4,641 |
| e. | Annual amount to be charged (C/D) | 1,00,000 |

(ii) Calculation of the amount of investments and interest

| Year | Opening Balance | Interest | Saving | Investments | Closing Balance |
|---|---|---|---|---|---|
| a | b | c = b×10/100 | d | e = c + d | f = b + e |
| 2009-10 | — | — | 1,00,000 | 1,00,000 | 1,00,000 |
| 2010-11 | 1,00,000 | 10,000 | 1,00,000 | 1,10,000 | 2,10,000 |
| 2011-12 | 2,10,000 | 21,000 | 1,00,000 | 1,21,000 | 3,31,000 |
| 2012-13 | 3,31,000 | 33,100 | 1,00,000 | — | — |

**(b) Given below is the Extract Trial Balance of Ramesh Ltd. and Dinesh Ltd. as on 31.3.2013. Dinesh Ltd. was merged with Ramesh Ltd. with effect from 01.04.2013.**

**Trial Balance (Extract) as on 31.3.2013 (`)**

| **Particulars** | **Ramesh Ltd.** | | **Dinesh Ltd.** | |
|---|---|---|---|---|
| | **Dr.** | **Cr.** | **Dr.** | **Cr.** |
| **Equity Shares of ` 10 each** | | **14,00,000** | | **5,00,000** |
| **General Reserve** | | **7,00,000** | | **2,40,000** |
| **Profit and Loss A/c** | | **4,20,000** | | **1,30,000** |
| **Export Profit Reserve** | | **1,40,000** | | **80,000** |
| **12% Debentures** | | **2,00,000** | | **2,00,000** |
| **Sundry Creditors** | | **80,000** | | **90,000** |
| **Provision for Taxation** | | **2,00,000** | | **1,20,000** |
| **Proposed Dividend** | | **2,80,000** | | **1,00,000** |
| **Sundry Fixed Assets (Tangible)** | **19,00,000** | | **8,00,000** | |
| **Investments (Non-trade)** | **4,00,000** | | **1,00,000** | |
| **Stock (opening)** | **2,40,000** | | **1,00,000** | |
| **Debtors** | **1,50,000** | | **1,60,000** | |
| **Advance Tax** | **1,60,000** | | **40,000** | |
| **Cash and Bank balances** | **5,50,000** | | **2,60,000** | |
| **Preliminary Expenses** | **20,000** | | | |
| **Total** | **34,20,000** | **34,20,000** | **14,60,000** | **14,60,000** |

**Closing Stock of Ramesh and Dinesh is also `2,40,000 & `1,00,000 respectively. Ramesh Ltd. would issue 12% Debentures to discharge the claims of the debenture holders of Dinesh Ltd. at par. Non-trade investments of Ramesh Ltd. fetched @ 25% while those of Dinesh Ltd. fetched @ 18%.**

**Profit (pre-tax) by Ramesh Ltd and Dinesh Ltd. during 2010-11, 2011-12 and 2012-13 and were as follows:**

| **Year** | **Ramesh Ltd.** | **Dinesh Ltd.** |
|---|---|---|
| | ` | ` |
| **2010-11** | **10,00,000** | **3,00,000** |
| **2011-12** | **13,00,000** | **4,20,000** |
| **2012-13** | **11,50,000** | **3,60,000** |

**Goodwill may be calculated on the basis of capitalisation method taking 20% as the pre-tax normal rate of return. Purchase consideration is discharged by Ram Ltd. on the basis of intrinsic value per share. Both companies decided to cancel the proposed dividend.**

**Required: Balance Sheet of Ramesh Ltd. after merger.** **[16]**

**Answer:**

WN # 1: Purchase Consideration:

| | | |
|---|---|---|
| (i) | Shares outstanding in Dinesh Ltd. | 50,000 |
| (ii) | Intrinsic Value per Share of Dinesh Ltd. [WN # 2] | ` 36.20 |
| (iii) | Value of Shares (a × b) | ` 18,10,000 |
| (iv) | Intrinsic value per share of Ramesh Ltd. [WN # 2] | ` 40.40 |
| (v) | No. of shares to be issued by Ramesh Ltd. | |

` 18,10,000/ ` 40.40 = 44,801.99

| Shares | Cash for fractions |
|---|---|
| 44,801 | 0.99 × 40.40 = 40 |

(iv) Purchase consideration

| | | |
|---|---|---|
| (a) 44,801 shares @ 40.40 | | |
| Capital [`10 / Share] | 4,48,010 | |
| Premium [`30.40 / Share] | 13,61,950 | = 18,09,960 |
| (b) Cash for fractional shares | | = 40 |
| (c) Total purchase consideration payable | | = 18,10,000 |

WH # 2: Intrinsic Value per share:

(`)

| | | Ramesh Ltd. | | Dinesh Ltd. | |
|---|---|---|---|---|---|
| (i) | Assets | | | | |
| (a) | Goodwill | 27,30,000 | | 7,60,000 | |
| (b) | Sundry Fixed assets | 19,00,000 | | 8,00,000 | |
| (c) | Investments | 4,00,000 | | 1,00,000 | |
| (d) | Stock | 2,40,000 | | 1,00,000 | |
| (e) | Debtors | 1,50,000 | | 1,60,000 | |
| (f) | Advance Tax | 1,60,000 | | 40,000 | |
| (g) | Cash and Bank Balance | 5,50,000 | 61,30,000 | 2,60,000 | 22,20,000 |
| (ii) | Liabilities | | | | |
| (a) | 12% Debentures | 2,00,000 | | 2,00,000 | |

| | | | | | |
|---|---|---|---|---|---|
| | (b) Sundry creditors | 80,000 | | 90,000 | |
| | (c) Provision for tax | 2,00,000 | (4,80,000) | 1,20,000 | (4,10,000) |
| (iii) | Net Assets (i-ii) | | 56,50,000 | | 18,10,000 |
| (iv) | No. of Outstanding Shares | | 1,40,000 | | 50,000 |
| (v) | Intrinsic Value per share (iii)/(iv) | | 40.40 | | 36.20 |

W # 3: Valuation of Goodwill

A. Capital Employed

| | | Ramesh Ltd. | | Dinesh Ltd. | |
|---|---|---|---|---|---|
| (i) | Assets: | | | | |
| | (a) Sundry Fixed assets | 19,00,000 | | 8,00,000 | |
| | (b) Investment (Non-trade) | - | | - | |
| | (c) Stock | 2,40,000 | | 1,00,000 | |
| | (d) Debtors | 1,50,000 | | 1,60,000 | |
| | (e) Advance tax | 1,60,000 | | 40,000 | |
| | (f) Cash and Bank balance | 5,50,000 | 30,00,000 | 2,60,000 | 13,60,000 |
| (ii) | Liabilities: | | | | |
| | (a) 12% Debentures | 2,00,000 | | [redacted] | |
| | (b) Sundry creditors | 80,000 | | 90,000 | |
| | (c) Provision for tax | 2,00,000 | 4,80,000 | 1,20,000 | 4,10,000 |
| (iii) | Capital Employed: (i) - (ii) | | 25,20,000 | | 9,50,000 |

B. Average Pre-tax Profit:

| | Particulars | Ramesh Ltd. | Dinesh Ltd. |
|---|---|---|---|
| (i) | 2010-11 | 10,00,000 | 3,00,000 |
| (ii) | 2011-12 | 13,00,000 | 4,20,000 |
| (iii) | 2012-13 | 11,50,000 | 3,60,000 |
| (iv) | Total (a+b+c) | 34,50,000 | 10,80,000 |
| (v) | Simple Average [(iv)/3] | 11,50,000 | 3,60,000 |
| (vi) | Less: Non-trading income | (1,00,000) | (18,000) |
| (vii) | Average pre-tax profit | 10,50,000 | 3,42,000 |

C. Computation of Goodwill:

| | Particulars | Ramesh Ltd. | Dinesh Ltd. |
|---|---|---|---|
| | | ` | ` |
| a. | Capitalised value of average profits $\frac{10,50,000}{0.20};\frac{3,42,000}{0.20}$ | 52,50,000 | 17,10,000 |
| b. | Capital Employed | 25,20,000 | 9,50,000 |
| c. | Goodwill (a-b) | 27,30,000 | 7,60,000 |

Journal Entries - Books of Ramesh Ltd.

- Nature of Amalgamation – PURCHASE
- Method of Accounting – PURCHASE METHOD

| | Particulars | | Debit | Credit |
|---|---|---|---|---|
| a. | For Business Purchase : | | | |
| | Business Purchase A/c | Dr. | 18,10,000 | |
| | To Liquidator of Dinesh Ltd. A/c | | | 18,10,000 |
| b. | For Assets and Liabilities taken over | | | |
| | Goodwill A/c | Dr. | 7,60,000 | |
| | Fixed Assets A/c | Dr. | 8,00,000 | |
| | Investments A/c | Dr. | 1,00,000 | |
| | Stock A/c | Dr. | 1,00,000 | |
| | Debtors A/c | Dr. | 1,60,000 | |
| | Advance tax A/c | Dr. | 40,000 | |
| | Cash and Bank A/c | Dr. | 2,60,000 | |
| | To 12% Debenture holders A/c | | | 2,00,000 |
| | To Creditors A/c | | | 90,000 |
| | To Provision for Taxation A/c | | | [redacted] |
| | To Business Purchase A/c | | | [redacted] |
| c. | For Discharge of Purchase Consideration: | | | |
| | Liquidator of Dinesh Ltd. | Dr. | 18,10,000 | |
| | To Equity Share capital A/c | | | 4,48,010 |
| | To Securities premium A/c | | | 13,61,950 |
| | To Cash A/c | | | 40 |
| d. | Contra Entry | | | |
| | Amalgamation Adjustment A/c | Dr. | 80,000 | |
| | To Export Profit Reserve A/c | | | 80,000 |

Name of the Company: Ramesh Ltd.

Balance Sheet as at 31.03.2013

| Ref No. | | Particulars | Note No. | As at 31st March, 2013 ` | As at 31st March, 2012 ` |
|---|---|---|---|---|---|
| | I. | Equity and Liabilities | | | |
| | 1 | Shareholders' funds | | | |
| | | (a) Share capital | 1 | 18,48,010 | |
| | | (b) Reserves and surplus | 2 | 29,81,950 | |
| | | (c) Money received against share warrants | | | |
| | 2 | Share application money pending allotment | | | |
| | 3 | Non-current liabilities | | | |

| | | | |
|---|---|---|---|
| | (a) Long-term borrowings | 3 | 4,00,000 |
| | (b)Deferred tax liabilities (Net) | | |
| | (c) Other Long term liabilities | | |
| | (d) Long-term provisions | | |
| 4 | Current Liabilities | | |
| | (a) Short-term borrowings | | |
| | (b) Trade payables | 4 | 1,70,000 |
| | (c) Other current liabilities | | |
| | (d) Short-term provisions | 5 | 3,20,000 |
| | Total (1+2+3+4) | | 57,19,960 |
| II. | Assets | | |
| 1 | Non-current assets | | |
| | (a) Fixed assets | | |
| | (i) Tangible assets | 6 | 27,00,000 |
| | (ii) Intangible assets | 7 | 7,60,000 |
| | (iii) Capital work-in-progress | | |
| | (iv) Intangible assets under development | | |
| | (b) Non-current investments | 8 | 5,00,000 |
| | (c) Deferred tax assets (Net) | | |
| | (d) Long-term loans and advances | 9 | 2,00,000 |
| | (e) Other non-current assets | 10 | 80,000 |
| 2 | Current assets | | |
| | (a) Current investments | | |
| | (b) Inventories | 11 | 3,40,000 |
| | (c) Trade receivables | 12 | 3,10,000 |
| | (d) Cash and cash equivalents | 13 | 8,09,960 |
| | (e) Short-term loans and advances | | |
| | (f) Other current assets | 14 | 20,000 |
| | Total (1+2) | | 57,19,960 |

Note to the Accounts:-

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| Note 1. Share Capital | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Authorised, Issued, Subscribed and Paid up Share Capital 1,84,801 Equity Shares of `10 each (of which 44,801 shares were issued for consideration other than cash) | 18,48,010 | |
| Total | 18,48,010 | |

| Note 2. Reserves and Surplus | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Securities Premium | 13,61,950 | |
| General Reserve | 7,0[illegible] | |
| Profit and Loss A/c `4,20,000<br>Add: Proposed Dividend Cancelled `2,80,000 | 7,00,000 | |
| Export Profit reserve (1,40,000+80,000) | 2,20,000 | |
| Total | 29,81,950 | |

| Note 3. Long-term borrowings | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| 12% Debentures of `100 each (2,00,000+2,00,000) | 4,00,000 | |
| Total | 4,00,000 | |

| Note 4. Trade Payables | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Sundry Creditors (80,000 + 90,000) | 1,70,000 | |
| Total | 1,70,000 | |

| Note 5. Short term Provisions | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Provision for Tax (2,00,000 + 1,20,000) | 3,20,000 | |
| Total | 3,20,000 | |

| Note 6. Tangible Assets | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Sundry Fixed assets (19,00,000 + 8,00,000) | 27,00,000 | |
| Total | 27,00,000 | |

| Note 7. Intangible assets | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Goodwill | 7,60,000 | |
| Total | 7,60,000 | |

| Note 8. Noncurrent Investments | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Investment (4,00,000 + 1,00,000) | 5,00,000 | |
| Total | 5,00,000 | |

| Note 9. Long-term Loans and advances | As at 31st March, [redacted] | [redacted] |
|---|---|---|
| Advance Tax (1,60,000 + 40,000) | 2,00,000 | |
| Total | 2,00,000 | |

| Note 10.Other Non-current assets | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Amalgamation Adjustment A/c | 80,000 | |
| Total | 80,000 | |

| Note 11. Inventories | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Stock (2,40,000 + 1,00,000) | 3,40,000 | |
| Total | 3,40,000 | |

| Note 12. Trade receivables | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Debtors (1,50,000 +1,60,000) | 3,10,000 | |
| Total | 3,10,000 | |

| Note 13. Cash and Cash Equivalents | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Cash and Bank balance (5,50,000 + 2,60,000 - 40) | 8,09,960 | |
| Total | 8,09,960 | |

| Note 14. Other Current Assets | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Preliminary Expenses | 20,000 | |
| Total | 20,000 | |

(c) **The following is the Extract Trial Balance of "Tarun Ltd". as on 30.09.2012: (Amount in `)**

| **Particulars** | | **Dr.** | **Cr.** |
|---|---|---|---|
| **11% Preference Shares of `10 each** | | | **2,00,000** |
| **20,000 Equity Shares of `10 each, fully paid** | | | **2,00,000** |
| **10,000 Equity Shares of ` 10 each, ` 7.50 paid** | | | **75,000** |
| **13% Debentures** | | | **3,00,000** |
| **Mortgage Loan** | | | **1,60,000** |
| **Bank Overdraft** | | | [redacted] |
| **Creditors for Trade** | | | [redacted] |
| **Arrears of Income tax (Assessments concluded in July 2004)** | | | |
| **Assessment Year 2010-2011 -** | **42,000** | | |
| **Assessment Year 2011-2012 -** | **10,000** | | **52,000** |
| **Land and Building** | | **2,40,000** | |
| **Sundry Current Assets** | | **7,90,000** | |
| **Profit & Loss Account** | | **77,000** | |
| **Debenture Issue expenses not written off** | | **4,000** | |
| **Total** | | **11,11,000** | **11,11,000** |

**Other Information**

- **Mortgage Loan was secured against Land and Buildings. Debentures were secured by a Floating Charge on all the other assets.**
- **The Company was unable to meet the payments and therefore the Debenture holders appointed a Receiver and this was followed by a resolution for Members Voluntary Winding Up.**
- **The Receiver for the Debenture holders brought the Land and Buildings to auction and realized `3,00,000. He also took charge of Sundry Assets of the value of `4,80,000 and realized `4,00,000.**
- **The Liquidator realized `2,00,000 on the sale of the balance of Sundry Current Assets.**
- **The Bank Overdraft was secured by a personal guarantee of two of the Directors of the Company and on the Bank raising a demand, the Directors paid off the dues from their personal resources.**
- **Costs incurred by the Receiver were ` 4,000 and by the Liquidator ` 5,600.**

- **The Receiver was not entitled to any remuneration but the Liquidator was to receive 3% Fee on the value of assets realized by him.**
- **Preference Shareholders had not been paid dividend for the period after 30.9.2010 and interest for the last half-year was due to Debenture holders.**

**From the above information, prepare the Liquidator's Receipts and Payments Account. [16]**

**Answer:**

Determination of Surplus received by Liquidator from Receiver

| Receipts | ` | Payments | ` |
|---|---|---|---|
| Land and Buildings | 3,00,000 | Debenture Interest (3,00,000 x 13% x 6/12) | 19,500 |
| Sundry Current Assets | 4,00,000 | Income Tax Arrears (42,000 + 10,000) | 52,000 |
| | | Expenses of Receiver Given | 4,000 |
| | | Mortgage Loan Given | 1,60,000 |
| | | Debenture holders Principal Amount | 3,00,000 |
| | | Balance Surplus handed over to [redacted] (b/f) | |
| Total | 7,00,000 | | 7,00,000 |

Liquidator's Receipts & Payments Account

| Receipts | ` | Payments | | ` |
|---|---|---|---|---|
| Surplus received from Receiver (WN 1) | 1,64,500 | Remuneration to Liquidator (2,00,000 x 3%) | | 6,000 |
| | | Cost of Liquidation | | 5,600 |
| Sundry Assets realized | 2,00,000 | Unsecured Creditors: | | |
| Calls on Contributories | 21,700 | - Trade Creditors | 64,000 | |
| - From 10,000 Partly Paid Shares at ` 2.17 per share (See WN 3 below) | | - Directors (for Bank Overdraft paid) | 60,000 | 1,24,000 |
| | | Preference Shareholders: | | |
| | | - Share Capital | 2,00,000 | |
| | | - Arrears of Dividend (2 yrs) | 44,000 | 2,44,000 |
| | | Equity Shareholders' Final Payment | | |
| | | - Return of money to holders of 20,000 Fully Paid Shares at ` 0.33 each | | 6,600 |
| Total | 3,86,200 | Total | | 3,86,200 |

Calls from Holders of Partly Paid Shares

| | Particulars | ` |
|---|---|---|
| a. | Total of Receipts before considering Call Money (1,64,500 + 2,00,000) | 3,64,500 |
| b. | Total Payments before final payment to Equity Shares (5,600 + 6,000 + 1,24,000 + 2,44,000) | 3,79,600 |
| c. | Deficit from above from Calls made on Equity Shares (a-b) | (15,100) |
| d. | Notional Call on 10,000 Partly Paid Shares at ` 2.50 each | 25,000 |
| e. | Surplus Cash Balance after Notional Call (comparing c and d) | 9,900 |
| f. | Number of Shares deemed fully paid (20,000 + 10,000) | 30,000 |
| g. | Hence, Refund on Fully Paid Shares ` 9,900 / 30,000 Shares (e ÷ f) | 33 paise |
| h. | Therefore, Required Call on Partly Paid Shares (2.50 – 0.33) | ` 2.17 |

# Section C

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

**(i) State the advantages of Social audit.**

**Answer:**

Advantages of Social audit

- Encourages community participation among different business entities.
- Ensures continuous efforts towards environmental protection and use of environment friendly production processes.
- Builds customer satisfaction and trust through ethical business practices.
- Promotes collective decision making and sharing responsibilities.
- Develops human resources by working towards improvement of workers' and the underprivileged persons' working/ living conditions.

**(ii) Explain the difference between a checklist and an Internal Control questionnaire.**

**Answer:**

Difference between a checklist and an Internal Control questionnaire

| S. No | Basis | Check List | Internal Control Questionnaire |
|---|---|---|---|

| | | | |
|---|---|---|---|
| a. | Point of Time | It is issued at the commencement of audit and reported back after completion of audit. | It can be issued at any point of time and reported back immediately. |
| b. | Issued To | It is issued to the audit staff to be followed by them during audit and reported back at completion. | It is issued to various people at different levels in the organization. |
| c. | Contents | It contains instructions to be followed by audit assistants. | It contains questions to be answered by the employees of the organization. |
| d. | Objective | It works as a guideline for audit staff so that no area remains unchecked | This is used to collect the information to know about the internal control system and evaluate the weaknesses therein. |

**(iii) Explain the difference between Test Check and Statistical Sampling.**

**Answer:**

Difference between Test Checking and Statistical Sampling

| S.No. | Basis | Test Checking | Statistical Sampling |
|---|---|---|---|
| a. | Selection | Selective transactions are verified. | Drawing a sample from a large number of transactions. |
| b. | Technique | No specific technique is used. | Statistical technique used is: selection on random basis. |
| c. | Subjective | It is subjective and depends upon the choice of the auditor. | It depends upon the statistical technique applied. |
| d. | Risk& Method | It involves more risk as there are no specific methods for test check. | It carries lesser risk and various statistical methods can be used at different times. |

**(iv) What types of analysis are covered by analytical procedures?**

**Answer:**

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

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

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

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

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

**(i) What are the matters should be considered by the auditor of the company while doing audit of Charitable Institutions? [8]**

**Answer:**

When conducting the audit of a charitable institution, the auditor should consider the following matters:

- The auditor should study the constitution of the charitable institution, [redacted] is set up under the Societies Registration Act or as per section 25 of the [redacted] a trust.
- Obtain a list of members of the governing body. This will help the auditor in identifying whether any of the members of the governing body has any interest in the charitable institution.
- The auditor should obtain a copy of the budget sanctioned or the financial statement. This would enable him to acquaint himself with the different heads of income and expenditures of incomes and expenditures of the institution.
- Examination of the system of internal check, especially as regards the accounting of the amounts collected.
- Check that the amounts received towards income have been duly collected, received and deposited into the bank regularly and promptly.
- These institutions receive subscriptions and donations which form the major part of their collections. Therefore the auditor should check the following:
- The amount or the rate of the annual subscription.
- Any instructions given by the donors as to the specific utilization of donation.
- Adequacy of internal controls existing as regards unused receipt books, counter foils, etc.
- Where subscriptions are received in advance these should be properly dealt with in the accounts.
- Verify the amounts of legacies received by reference to correspondence with any figures and other available informations.
- Where the institution has made any investments or given loans, the amount of dividend and interest should be properly vouched with reference to the counterfoils or dividend warrants

received. It should be ensured that such loans or grants are given under proper authorizations.

- If some property is given or taken on rent, then the auditor should check the tenancy agreement, the rent slips and the authorized person for the collection or payment, as the case may be, of the rent.
- Most of the organisations organize special functions such as concert etc. The auditor should be careful in such cases. All the gross receipts and outgoings are to be properly vouched by him. It should be ensured that proper internal check was maintained as regards the receipts and outgoings. For example, the person responsible for collection and disbursements should be separate persons.
- The expenditure of charitable institution is also one of the major areas of concern. Thus the auditor should verify that the expenditure is made only for the charitable purpose. If the expenditure is not for the charitable purpose, then the auditor should examine the implications of applicable law and document for the same.
- The auditor should physically verify the cash in hand, inventories and fixed assets.

**(ii) What are the scope of Audit Committee of the company?**

**Answer:**

An Audit Committee consists of three to five members formed to serve as communication link among various departments. Audit Committee has a fourfold relationship and therefore has to interact with management, internal auditor, statutory auditor and the public.

The Scope of Audit Committee can be discussed as follows: -

- Review of annual financial statements before submission to the Board of Directors.
- Selection of the Statutory Auditor
- Act as lies on between the Statutory Auditor and Board of Directors
- Administrative control of the internal control functions through the feedback between the Internal Auditor and the Audit Committee.
- Over seeing internal central operation.
- Over seeing internal audit operations and feedback between internal audit committee and developing the internal auditing authority through broad based internal audit programming.
- Review and approval of financial information for publication
- Review proposed changes in accounting system and procedures.
- Help resolve differences between management, internal and statutory auditor.
- Report on the audit committee acting in the Annual Reports of Board of Directors.
- Ensure reliability of organisation's financial statements and operational activities. To be effective and purposeful, the audit committee should maintain the following:-

- Audit Committee should have the independence of management, Statutory Auditor and Internal Auditor. The Board of Directors allows full freedom to the audit committee to investigate into any areas of operation.
- The relation between the audit committee and management should be cordial and congenial towards optimum efficiency and healthy growth of the organization.
- There should be a regular line of communication through occasional meetings with the management.
- There should be good communication relationship interwoven among management, internal auditor and statutory auditor.

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

(a) **How to verify the following –** **[3x4 = 12]**
**(i) Verification of Contingent Liability**
**(ii) Verification of Plant & Machinery**
**(iii) Freehold Land & Building**

**Answer:**
(i) Verification of Contingent Liability

Auditor should carefully verify contingent liabilities as it may become actual liability on happening or not happening certain events and while verifying keep in mind following points.

- Obtain certificate about the contingent liabilities disclosed in the Balance Sheet, from a responsible officer.
- Carefully examine whether such liabilities are in existence or not.
- Check relevant documents to confirm the existence of contingent liability.
- Verify the certified list given by responsible officer to ascertain whether there exists any contingent liability which may turn to be an actual liability.
- Verify whether proper provision is made or not for the contingent liability turned out to be an actual liability.
- Verify bill discounting register, investment register, minute book and other relevant records to establish the amount of contingent liability.
- See whether contingent liability is properly disclosed in the Balance Sheet.

**(ii) Verification of Plant & Machinery**

As in case of industrial concern out of total assets 20% to 50% cost is that of Plant & Machinery and hence the auditor is required to take much more precaution while verifying the Plant and Machinery and for this he should give attention to following points-

- He should get the detailed list of all Plant and Machineries and asset wise accumulated depreciation.
- He should trace the opening balance in the Plant & Machinery register with the help of last year's audited balance sheet.

- He should verify quotations, invoices, cost etc., in connection with Purchase of Plant & Machinery. If there are sales of Plant & Machinery in audit period he should verify the invoice to that effect. He should check the Board Resolution authorizing Purchases of Plant & Machinery.
- If any machinery is disposed off and sold as scrap during the audit period, he should check the authorization and values report in that connection.
- He should check the rates and calculation of depreciation and ensure these are according to the provision of Section 205 of the Companies Act, 1956.
- He should check whether related expenses incurred on purchases of machinery are duly capitalized.
- He should check whether proper accounting of profit earned or loss suffered on Sale of Machinery, during the audit period, is done.
- If any machine is manufactured by the client itself, auditor should verify that capitalization of material, labor and other expenses is properly done.
- He should obtain from the Company management certificate about the verification of all items as required under CARO.
- He should scan the Plant register and physically inspect some of the major plants by visiting to the works.
- He should, finally, ensure appropriate disclosure of all information on the balance sheet as required by the Companies Act.
- He should obtain a certificate from the local auditor to that effect, if Plant and Machinery is kept abroad at a distant place.

**(iii) Freehold Land & Building**

- He should see that Freehold Land and Buildings are shown separately and not mixed with lease hold or other assets.
- He should see that separate accounts for land and for buildings are mentioned because on land usually no depreciation is provided.
- He should see that the balance shown on Balance Sheet is directly traceable from respective ledger account.
- He should examine the title deeds of the property and see that the asset is in the name of the client and in the free and fair possession of the client.
- He should examine that the title deed is genuine.
- The Purchases during the year be examined with the related correspondence, broker's note, auctioneer's note.
- In case of construction of the building auditor should examine the various certificates such as Builder's certificate, Contractor's certificates, Architect's certificate, Local authority certificate where needed.
- He should verify the sale, if a part of property has been sold during the period under audit.
- He should obtain a certificate from mortgagee if the property has been mortgaged and the deeds are with the mortgagee to verify the property.
- Land is not subject to depreciation but see that proper depreciation is provided on building as per the provision of Sec 205 of the Companies Act, 1956.

- See that the fluctuation in the value is not to be considered on Balance Sheet but if it has been considered then see that this is properly disclosed on Balance Sheet.
- Auditor should physically verify the existence of asset.

(b) **(i) Explain the features and Scope of an Internal Audit.** **[6]**

**Answer:**

Features of Internal Audit

- It is an independent appraisal activity within the organization.
- It can be conducted by the staff of the entity or by an independent professional appointed for that purpose.
- It is conducted for review of accounting, financial and other operations and controls established within an organization.
- It is conducted as a service to the organization and is not a part of the organization.
- It intends to furnish the analysis, appraisals, suggestions and information concerning the activities reviewed to the management.
- Internal auditing functions as a continuous effort for promoting effective control at cost reasonable cost.

Scope

The Institute of Internal Auditors defines scope of internal auditing as 'examination and evaluation of the adequacy and effectiveness of organisation's system of internal control and the quality of actual performance'. Therefore, internal auditing is concerned with an evaluation of both internal control as well as the quality of actual performance. According to the Institute, the scope of internal audit involves the following:

- Review the reliability and integrity of financial and operating information and the means to locate, identify, measure, classify and report such information.
- Appraise the economy and efficiency with which resources are employed.
- Review the systems established to ensure compliance with those policies, plans, procedures, laws and regulations which could have a significant effect and impact on operations and report, and should determine whether the organization is in compliance.
- Review the means of safeguarding assets and as appropriate verify the existence of such assets.
- Review operations or programs to ascertain whether results are consistent with established objectives and goals and whether the operations or programs are being carried out as planned.
- Internal auditing, therefore, is a function distinct from authorization and recording. It is concerned not only with examination of the transaction as recorded in the books of accounts but also with appraisal or procedure with a view to effecting change for better efficiency, where possible.

**(ii) What are the difference between Internal Audit and External Audit?** **[6]**

**Answer:**

Distinction between Internal Audit and External Audit

On accounting matters, the internal and external auditors operate mainly in the same field and they have a common interest in ascertaining that there is an effective system of internal control for presentation and detection of errors and frauds and to ensure that it is operating satisfactorily and that an adequate accounting system exists to provide the information necessary for preparing true and fair financial statements. There are some fundamental differences between the work of an internal auditor and that of an external auditor regarding the following:

- Appointment: The internal auditor is appointed by the management, generally the Directors and is responsible to them.
- The external or the statutory auditor is appointed according to the concerned statute. Generally, in case of company form of organization, the auditors are appointed by the shareholders in the annual general meeting.
- Scope: The extent of the work undertaken by the internal auditor is determined the management.
- The external auditor undertakes the area of the work which arises from the responsibilities placed on him by the governing statute.
- Approach: The internal auditor's approach is with a view to ensure that the accounting system is efficient, so that the accounting information presented to management throughout the period is accurate and discloses material facts.
- The external auditor's approach is governed by his responsibility to satisfy himself that the accounts to be presented to the shareholders show a true and fair view of the profit or loss for the financial period and of the company's state of affairs at the end of that period.
- Responsibility: The internal auditor's responsibility is to the management. It follows that the internal auditors, being a servant of the company, does not have independence of status.
- The external auditors, however, is responsible directly to the shareholders. Unlike the internal auditors, he is a representative of the shareholders and has independence of status.
- Objective: The main objective of internal audit is to ensure that the laid down policies, procedures and other internal control functions are functioning as designed.
- Whereas the objective of the external auditor is to express opinion and view to on financial statements whether those statements are showing true and fair view of the organisation.
- Independence: External auditor is more independent than internal auditor in the field of reporting.

Except these important differences, the work of both the internal auditor and the external auditor, on matters of accounting, is carried out largely by similar means, such as:

- Examination of the system of internal check, for both soundness and principle and effectiveness in operation.
- Examination and checking of accounting records and statements.
- Verification of assets and liabilities.
- Observations, inquiry, making of statistical comparisons and such other measures as may be judged necessary.

The wide experience of the external auditor may be of assistance to the internal auditor: while on the other side the latter's intimate acquaintance with business concern may be of help to the external auditors. Co-operation in planning of the respective auditors may save unnecessary works, although the external auditors must always satisfy himself as to the work carried out by the internal auditors.

**(c) (i) On the audit of Dreamlight Ltd. the audit partner of the engagement set the preliminary level of audit materiality at `12,00,000. After, the partner reviewed the audit of senior's assessment of inherent risk, he decided that the materiality level should be increased to `18,00,000.**

**Required:**

**A. What is the relationship between materiality and audit risk?**

**B. How will this new level of materiality affect the nature and extent of auditing procedures? [8]**

**Answer:**

**A.** The relationship between materiality and audit risk:

The concept of materiality is applied by the auditor both in planning and [redacted] and in evaluating the effect of identified misstatements on the audit [redacted] misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

In planning the audit, the auditor makes judgments about the size of misstatements that will be considered material. These judgments provide a basis for:

- Determining the nature, timing and extent of risk assessment procedures;
- Identifying and assessing the risks of material misstatement; and
- Determining the nature, timing and extent of further audit procedures.

In conducting an audit of financial statements, the overall objectives of the auditor are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and to report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings. The auditor obtains reasonable assurance by obtaining sufficient appropriate audit evidence to reduce audit risk to an acceptably low level. Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk. Materiality and audit risk are considered throughout the audit, in particular, when:

- Identifying and assessing the risks of material misstatement;
- Determining the nature, timing and extent of further audit procedures; and
- Evaluating the effect of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

**B.** The auditor shall revise materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) in the event of becoming aware of information during the audit that would have

caused the auditor to have determined a different amount (or amounts) initially (Initially `12,00,000 and revised at `18,00,000).

If the auditor concludes that a lower materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) than that initially determined is appropriate, the auditor shall determine whether it is necessary to revise performance materiality, and whether the nature, timing and extent of the further audit procedures remain appropriate.

Materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) may need to be revised as a result of a change in circumstances that occurred during the audit (for example, a decision to dispose of a major part of the entity's business), new information, or a change in the auditor's understanding of the entity and its operations as a result of performing further audit procedures. For example, if during the audit it appears as though actual financial results are likely to be substantially different from the anticipated period end financial results that were used initially to determine materiality for the financial statements as a whole, the auditor revises that materiality.

**(ii) Explain the difference between Qualified Report and Adverse Report. [4]**

**Answer:**

Distinguish Between Qualified Report and Adverse Report

| | Qualified Report | Adverse Report |
|---|---|---|
| i. | A Qualified Audit Report is one an Auditor gives an opinion subject to certain reservations. | An Adverse Report is given when the concludes that based on his examination, he does not agree with the affirmations made in the Financial Statements / Financial Report. |
| ii. | The Auditor's reservation is generally Stated as: "Subject to the above, we report that the Balance Sheet shows a true and fair view." | The Auditor states that the Financial Statements do not present a true and fair view of the state of affairs and working results of the organisation. |
| iii. | The accounts present a true and fair view subject to certain reservations. | The accounts do not present a true and fair view on the whole. |
| iv. | A Qualification is made in the Audit Report when the Auditor has reservation on specific item(s) of material nature. | An Adverse Report is given when the Auditor has his reservations on the true and fair view presented by the Financial Statements. |

## Paper 12 - Company Accounts & Audit

**Full Marks: 100**

# Section A

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

**(i) Differentiate between Reporting Currency and Foreign Currency.**

**Answer:**

Difference between Reporting Currency and Foreign Currency

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

**(ii) Define Financial Assets and Financial Liability as per AS 20.**

**Answer:**

Financial Asset: A Financial Asset is any asset that is –
(a) Cash
(b) A contractual right to receive cash or another Financial Asset from another Enterprise,
(c) A contractual right to exchange Financial Instruments with another Enterprise, under conditions that are potentially favorable, or
(d) An Equity Share of another Enterprise.

Financial Liability: A Financial Liability is any liability that is a contractual obligation –
(a) To deliver cash or another Asset to another Enterprise, or
(b) To exchange Financial Instruments with another Enterprise, under conditions that are potentially unfavourable.

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

**(a) Explain the objective of Financial Statements. [8]**

**Answer:**

Objective of Financial Statements

The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions. This would guide in deciding statements, their contents and disclosures.

A set of general purpose financial statements focus on financial position, performance and cash flows of an entity which could be used by any user group to assess investment decision,

employment stability or growth, debt servicing, business continuity and ability to make societal contribution. General purpose financial statements are those intended to meet the needs of users who are not in a position to require an entity to prepare reports tailored to their particular information needs.

A complete set of financial statements as worked out in Para 10 of IAS 1 is the outcome of the Framework which in turn is linked to subserve the information need of various user-groups. It comprises of:

(i) a statement of financial position as at the end of the period;

(ii) a statement of comprehensive income for the period ;

(iii) a statement of changes in equity for the period;

(iv) a statement of cash flows for the period;

(v) notes, comprising a summary of significant accounting policies and other explanatory information; and

(vi) a statement of financial position as at the beginning of the earliest comparative period when an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements.

Notes, comprising a summary of significant accounting policies and other explanatory information are important components of financial statements as they explain various elements of financial statements. Disclosure of risks adds to the information content of the financial statements.

Earning per share information contained in the Income Statement is focused information to shareholders as regards entity's performance. Information regarding diluted earning improves the information communique working out the effect of possible equity dilution actions. Similarly, segment reporting is intended to provide disaggregated information based on operating and / or geographic segments, consolidated financial statements focus on providing aggregated financial information for the entity-group as a whole, related party disclosures are intended to highlight non-market oriented transactions, if any. Thus the origination and improvement in disclosure and presentation standards have the purpose of making a set of general purpose financial statements useful to the diverse user-groups.

**(b) (i) Compute Basic Earnings Per Share from the following information –**

| Date | Particulars | No. of Shares |
|---|---|---|
| **1st April 2011** | **Balance at the beginning of the year** | **1,500** |
| **1st August 2011** | **Issue of Shares for Cash** | **600** |
| **31st March 2012** | **Buy back of Shares** | **500** |

**Net Profit for year ended 31st March 2012 was `2,75,000.** **[4]**

**Answer:**

1. Computation of Weighted Average Number of Shares outstanding during the period

| Date | No. of Equity share | Period Outstanding | Time Weighting factor | Weighted Avg. No. of Shares |
|---|---|---|---|---|
| (1) | (2) | (3) | (4) | (5)= (2) x (4) |
| 1st April 2011 | (Opening) 1,500 | 12 months | 12/12 | 1,500 |
| 1st August 2011 | (Fresh Issue) 600 | 8 months | 8/12 | 400 |
| 31st March 2012 | (Buy Back) 500 | 0 Months | 0/12 | - |

Weighted average Number of Equity Shares Outstanding during the period 1,900

2. Basic EPS = $\dfrac{\text{Net Profit or Loss attributable to Equity Shareholders}}{\text{Weighted Average Number of Equity shares Outstanding}}$

$= \dfrac{\text{` } 2{,}75{,}000}{1{,}900 \text{ Shares}} = \text{`}144.74$ per Share.

**(ii) Discuss the accounting treatment for Operating Leases in the Financial statements of Lessor. [4]**

**Answer:**

(a) Asset Recognition: The Lessor should present an Asset given under Operating Lease in its Balance Sheet under Fixed Assets.
(b) Income Recognition: Lease Income (excluding receipts for services provided, e.g. insurance and maintenance), should be recognised in the Statement of Profit and Loss on a Straight Line Basis over the Lease Term, even if it is not received on that basis, unless another systematic basis is more representative of the time pattern in which benefit derived from the use of the leased asset is diminished.
(c) Cost Recognition: Costs, including Depreciation, incurred in earning the Lease Income are recognised as an Expense.
(d) Initial Direct Costs: Initial Direct Costs incurred specifically to earn revenues are either - (a) deferred and allocated to income over the lease term in proportion [redacted] Rent Income, or (b) are recognised as an Expense in the Statement [redacted] period in which they are incurred.
(e) Depreciation: Depreciation of Leased Assets should be on a basis consistent with the normal depreciation policy of the Lessor for similar assets. The Depreciation charge should be calculated on the basis set out in AS - 6.
(f) Impairment Losses: The Lessor should apply AS - 28 to determine whether a Leased Asset has become impaired, and treat such impairment accordingly.
(g) Selling Profit: A Manufacturer or Dealer Lessor does not recognise any Selling Profit on entering into an Operating Lease, because it is not the equivalent of a sale.

**(c) Write short notes on recognition of Past Service Cost. [8]**

**Answer:**

1. Recognition as Expense:
   (a) In measuring its Defined Benefit Liability under Para 55, an Enterprise should recognise Past Service Cost as an expense, on a straight-line basis over the average period until the benefits become vested.
   (b) To the extent that the benefits are already vested immediately following the introduction of, or changes to, a Defined Benefit Plan, an enterprise should recognise Past Service Cost immediately.

   Example:

   An Enterprise operates a pension plan that provides a pension of 2% of final salary for each year of service. The benefits become vested after 5 years of service. On 1st January 20X4, the Enterprise improves the pension to 2.5% of final salary for each year of service starting from 1st January 20X0.

   Suppose, at the date of the improvement, the PV of the additional benefits for service from 1st Jan 20X0 to 1st January 20X4 is as follows -

| | |
|---|---|
| Employees with more than 5 years' service at 01.01.20X4 | `150 |
| Employees with less than 5 years' service at 01.01.20X4 | `120 |
| (Average period until vesting: 3 years) | |
| | `270 |

In this case, the Enterprise should recognise `150 immediately because those benefits are already vested. The Enterprise should recognise `120 on a straight-line basis over 3 years from 1st January 20X4.

2. Amendment of Amortisation Schedule: An Enterprise establishes the amortisation schedule for Past Service Cost when the benefits are introduced or changed. It would be impracticable to maintain the detailed records needed to identify and implement subsequent changes in that amortisation schedule. Also, the effect is likely to be material only where there is a curtailment or settlement. So, an Enterprise should amend the amortisation schedule for Past Service Cost, only if there is a curtailment or settlement.
3. Negative Past Service Cost: Where an Enterprise reduces benefits payable under an existing Defined Benefit Plan, the resulting reduction in the Defined Benefit Liability is recognised as (negative) Past Service Cost over the average period, until the reduced portion of the benefits becomes vested.
4. Net Change: Where an Enterprise reduces certain benefits payable under an existing Defined Benefit Plan and, at the same time, increases other benefits payable under the plan for the same employees, the Enterprise treats the change as a single net change.

# Section B

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

**(i) Explain the disclosure requirement of Deferred tax assets.**

**Answer:**

Deferred Tax Asset - Disclosure requirement

To be shown as a separate line item on the face of Balance Sheet.

**(ii) Explain the disclosure requirement of Intangible assets under development.**

**Answer:**

Intangible Assets under Development - Disclosure requirement

To be shown as a separate line item on the face of Balance Sheet.

Note - Intangible Assets under development should be disclosed under this head provided they can be recognized based on the criteria laid down in AS-26.

**(iii) What is meant by List B of Contributories?**

**Answer:**

a) Persons: Shareholders who had transferred Partly Paid Shares (otherwise than by operation of law or by death) within one year, prior to the date of winding up may be called upon to pay an

amount to pay off such Creditors as existed on the date of transfer of shares. These Transferors are called as B List Contributories.

b) Liability: Their liability is restricted to the amount not called up when the shares were transferred. They cannot be called upon to pay more than the entire face value of the share. For example, if Shares having Face Value of `100 were paid up `60, the B List Contributory can be called up to pay a maximum of `40 only.

c) Conditions: Liability of B List Contributories will crystallize only (a) when the existing assets available with the liquidator are not sufficient to cover the liabilities; (b) when the existing shareholders fail to pay the amount due on the shares to the Liquidator.

**(iv) What are the disclosure requirements of reportable segment under AS 17?**

**Answer:**

An enterprise should disclose the following for each reportable segment:

(a) segment revenue, classified into segment revenue from sales to external customers and segment revenue from transactions with other segments;
(b) segment result;
(c) total carrying amount of segment assets;
(d) total amount of segment liabilities;
(e) total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (tangible and intangible fixed assets);
(f) total amount of expense included in the segment result for depreciation and amortisation in respect of segment assets for the period; and
(g) total amount of significant non-cash expenses, other than depreciation and amortisation in respect of segment assets, that were included in segment expense and, therefore, deducted in measuring segment result.

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

**(a) On 1st April 2009, Gravity Ltd. issued 442, 10% Debentures of ` 1000 each at a discount of 10% redeemable at a premium of 5% after 4 years. It was decided to create a Sinking Fund for the purposes of accumulating sufficient funds to redeem the Debentures and to invest in some radily convertible securities yielding 10% interest p.a. Reference to the table shows that `1.00 p.a. at 10% compound interest amounts to `4.641 in 4 years. Investments are to be made in the Bonds of `1000 each available at par.**

**On 31st March 2013, the investments realised `3,40,000 and debentures were redeemed. The bank balance as on that date was `50,000.**

**Required: Prepare Debenture Redemption Fund Account and Debenture Redemption Fund Investments Account for 4 years. [16]**

**Answer:**

DRF = Debenture Redemption Fund, DRFI = Debenture Redemption Fund Investment

Dr. Discount on Issue of Debentures Account Cr.

| Date | Particulars | ` | Date | Particulars | ` |
|---|---|---|---|---|---|
| 31.03.10 | To Balance c/d | 1,00,000 | 31.03.10 | By P & L App. A/c | 1,00,000 |
| 31.03.11 | To Balance c/d | 2,10,000 | 01.04.10 | By Balance b/d | 1,00,000 |
| | | | 31.03.11 | By Interest on DRFI A/c | 10,000 |
| | | | | By P & L App. A/c | 1,00,000 |
| | | 2,10,000 | | | 2,10,000 |
| 31.03.12 | To Balance c/d | 3,31,000 | 01.04.11 | By Balance b/d | 2,10,000 |
| | | | | By Interest on DRFI A/c | 21,000 |
| | | | | By P & L App. A/c | 1,00,000 |
| | | 3,31,000 | | | 3,31,000 |
| 31.03.13 | To Loss on issue of Debentures (premium) | 22,100 | 01.04.12 | By Balance b/d | 3,31,000 |
| | To Debenture Redemption Reserve A/c | 4,52,000 | | By Interest on DRFI A/c | 33,100 |
| | | | | By P & L App. A/c | 91,000 |
| | | | | By Debenture [redacted] | |
| | | | | Investment A/c [redacted] | |
| | | 4,74,100 | | | 4,74,100 |

Dr. Debentures Redemption Fund Investment (DRFI) Account Cr.

| Date | Particulars | ` | Date | Particulars | ` |
|---|---|---|---|---|---|
| 31.03.10 | To Bank A/c | 1,00,000 | 31.03.10 | By Balance c/d | 1,00,000 |
| 01.04.10 | To Balance b/d | 1,00,000 | 31.03.11 | By Balance c/d | 2,10,000 |
| 31.03.11 | To Bank A/c | 1,10,000 | | | |
| | | 2,10,000 | | | 2,10,000 |
| 01.04.11 | To Balance b/d | 2,10,000 | 31.03.12 | By Balance c/d | 3,31,000 |
| 31.03.12 | To Bank A/c | 1,21,000 | | | |
| | | 3,31,000 | | | 3,31,000 |
| 01.04.12 | To Balance b/d | 3,31,000 | 31.03.13 | By Bank A/c (Sales) | 3,50,000 |
| 31.03.13 | To Debenture Redemption Fund A/c (Profit) | 9,000 | | | |
| | | 3,50,000 | | | 3,50,000 |

**Working Note:**

(i) Calculation of the amount of profit set aside

| | | ` |
|---|---|---|
| a. | Face Value of Debentures | 4,42,000 |

| | | |
|---|---|---|
| b. | Premium Payable on Redemption | 22,100 |
| c. | Depreciable Cost (A + B) | 4,64,100 |
| d. | Value of annuity per `1 | 4,641 |
| e. | Annual amount to be charged (C/D) | 1,00,000 |

(ii) Calculation of the amount of investments and interest

| Year | Opening Balance | Interest | Saving | Investments | Closing Balance |
|---|---|---|---|---|---|
| a | b | c = b×10/100 | d | e = c + d | f = b + e |
| 2009-10 | — | — | 1,00,000 | 1,00,000 | 1,00,000 |
| 2010-11 | 1,00,000 | 10,000 | 1,00,000 | 1,10,000 | 2,10,000 |
| 2011-12 | 2,10,000 | 21,000 | 1,00,000 | 1,21,000 | 3,31,000 |
| 2012-13 | 3,31,000 | 33,100 | 1,00,000 | — | — |

**(b) Given below is the Extract Trial Balance of Ramesh Ltd. and Dinesh Ltd. as on 31.3.2013. Dinesh Ltd. was merged with Ramesh Ltd. with effect from 01.04.2013.**

**Trial Balance (Extract) as on 31.3.2013** **(`)**

| **Particulars** | **Ramesh Ltd.** | | **Dinesh Ltd.** | |
|---|---|---|---|---|
| | **Dr.** | **Cr.** | **Dr.** | **Cr.** |
| **Equity Shares of ` 10 each** | | **14,00,000** | | **5,00,000** |
| **General Reserve** | | **7,00,000** | | **2,40,000** |
| **Profit and Loss A/c** | | **4,20,000** | | **1,30,000** |
| **Export Profit Reserve** | | **1,40,000** | | **80,000** |
| **12% Debentures** | | **2,00,000** | | **2,00,000** |
| **Sundry Creditors** | | **80,000** | | **90,000** |
| **Provision for Taxation** | | **2,00,000** | | **1,20,000** |
| **Proposed Dividend** | | **2,80,000** | | **1,00,000** |
| **Sundry Fixed Assets (Tangible)** | **19,00,000** | | **8,00,000** | |
| **Investments (Non-trade)** | **4,00,000** | | **1,00,000** | |
| **Stock (opening)** | **2,40,000** | | **1,00,000** | |
| **Debtors** | **1,50,000** | | **1,60,000** | |
| **Advance Tax** | **1,60,000** | | **40,000** | |
| **Cash and Bank balances** | **5,50,000** | | **2,60,000** | |
| **Preliminary Expenses** | **20,000** | | | |
| **Total** | **34,20,000** | **34,20,000** | **14,60,000** | **14,60,000** |

**Closing Stock of Ramesh and Dinesh is also `2,40,000 & `1,00,000 respectively. Ramesh Ltd. would issue 12% Debentures to discharge the claims of the debenture holders of Dinesh Ltd. at par. Non-trade investments of Ramesh Ltd. fetched @ 25% while those of Dinesh Ltd. fetched @ 18%.**

**Profit (pre-tax) by Ramesh Ltd and Dinesh Ltd. during 2010-11, 2011-12 and 2012-13 and were as follows:**

| **Year** | **Ramesh Ltd.** | **Dinesh Ltd.** |
|---|---|---|
| | ` | ` |
| **2010-11** | **10,00,000** | **3,00,000** |
| **2011-12** | **13,00,000** | **4,20,000** |
| **2012-13** | **11,50,000** | **3,60,000** |

**Goodwill may be calculated on the basis of capitalisation method taking 20% as the pre-tax normal rate of return. Purchase consideration is discharged by Ram Ltd. on the basis of intrinsic value per share. Both companies decided to cancel the proposed dividend.**

**Required: Balance Sheet of Ramesh Ltd. after merger.** **[16]**

**Answer:**

WN # 1: Purchase Consideration:

| | | |
|---|---|---|
| (i) | Shares outstanding in Dinesh Ltd. | 50,000 |
| (ii) | Intrinsic Value per Share of Dinesh Ltd. [WN # 2] | ` 36.20 |
| (iii) | Value of Shares (a × b) | ` 18,10,000 |
| (iv) | Intrinsic value per share of Ramesh Ltd. [WN # 2] | ` 40.40 |
| (v) | No. of shares to be issued by Ramesh Ltd. | |

` 18,10,000/ ` 40.40 = 44,801.99

| Shares | Cash for fractions |
|---|---|
| 44,801 | 0.99 × 40.40 = 40 |

(iv) Purchase consideration

| | | |
|---|---|---|
| (a) 44,801 shares @ 40.40 | | |
| Capital [`10 / Share] | 4,48,010 | |
| Premium [`30.40 / Share] | 13,61,950 | = 18,09,960 |
| (b) Cash for fractional shares | | = 40 |
| (c) Total purchase consideration payable | | = 18,10,000 |

WH # 2: Intrinsic Value per share:

(`)

| | | | Ramesh Ltd. | | Dinesh Ltd. |
|---|---|---|---|---|---|
| (i) | Assets | | | | |
| | (a) Goodwill | 27,30,000 | | 7,60,000 | |
| | (b) Sundry Fixed assets | 19,00,000 | | 8,00,000 | |
| | (c) Investments | 4,00,000 | | 1,00,000 | |
| | (d) Stock | 2,40,000 | | 1,00,000 | |
| | (e) Debtors | 1,50,000 | | 1,60,000 | |
| | (f) Advance Tax | 1,60,000 | | 40,000 | |
| | (g) Cash and Bank Balance | 5,50,000 | 61,30,000 | 2,60,000 | 22,20,000 |
| (ii) | Liabilities | | | | |
| | (a) 12% Debentures | 2,00,000 | | 2,00,000 | |

| | | | | | |
|---|---|---|---|---|---|
| | (b) Sundry creditors | 80,000 | | 90,000 | |
| | (c) Provision for tax | 2,00,000 | (4,80,000) | 1,20,000 | (4,10,000) |
| (iii) | Net Assets (i-ii) | | 56,50,000 | | 18,10,000 |
| (iv) | No. of Outstanding Shares | | 1,40,000 | | 50,000 |
| (v) | Intrinsic Value per share (iii)/(iv) | | 40.40 | | 36.20 |

W # 3: Valuation of Goodwill

A. Capital Employed

| | | Ramesh Ltd. | | Dinesh Ltd. | |
|---|---|---|---|---|---|
| (i) | Assets: | | | | |
| | (a) Sundry Fixed assets | 19,00,000 | | 8,00,000 | |
| | (b) Investment (Non-trade) | - | | - | |
| | (c) Stock | 2,40,000 | | 1,00,000 | |
| | (d) Debtors | 1,50,000 | | 1,60,000 | |
| | (e) Advance tax | 1,60,000 | | 40,000 | |
| | (f) Cash and Bank balance | 5,50,000 | 30,00,000 | 2,60,000 | 13,60,000 |
| (ii) | Liabilities: | | | | |
| | (a) 12% Debentures | 2,00,000 | | [redacted] | |
| | (b) Sundry creditors | 80,000 | | 90,000 | |
| | (c) Provision for tax | 2,00,000 | 4,80,000 | 1,20,000 | 4,10,000 |
| (iii) | Capital Employed: (i) - (ii) | | 25,20,000 | | 9,50,000 |

B. Average Pre-tax Profit:

| Particulars | | Ramesh Ltd. | Dinesh Ltd. |
|---|---|---|---|
| (i) | 2010-11 | 10,00,000 | 3,00,000 |
| (ii) | 2011-12 | 13,00,000 | 4,20,000 |
| (iii) | 2012-13 | 11,50,000 | 3,60,000 |
| (iv) | Total (a+b+c) | 34,50,000 | 10,80,000 |
| (v) | Simple Average [(iv)/3] | 11,50,000 | 3,60,000 |
| (vi) | Less: Non-trading income | (1,00,000) | (18,000) |
| (vii) | Average pre-tax profit | 10,50,000 | 3,42,000 |

C. Computation of Goodwill:

| Particulars | | Ramesh Ltd. | Dinesh Ltd. |
|---|---|---|---|
| | | ` | ` |
| a. | Capitalised value of average profits | | |
| | $\frac{10,50,000}{0.20}; \frac{3,42,000}{0.20}$ | 52,50,000 | 17,10,000 |
| b. | Capital Employed | 25,20,000 | 9,50,000 |
| c. | Goodwill (a-b) | 27,30,000 | 7,60,000 |

Journal Entries - Books of Ramesh Ltd.

- Nature of Amalgamation – PURCHASE
- Method of Accounting – PURCHASE METHOD

| Particulars | | Debit | Credit |
|---|---|---|---|
| a. For Business Purchase : | | | |
| Business Purchase A/c | Dr. | 18,10,000 | |
| To Liquidator of Dinesh Ltd. A/c | | | 18,10,000 |
| b. For Assets and Liabilities taken over | | | |
| Goodwill A/c | Dr. | 7,60,000 | |
| Fixed Assets A/c | Dr. | 8,00,000 | |
| Investments A/c | Dr. | 1,00,000 | |
| Stock A/c | Dr. | 1,00,000 | |
| Debtors A/c | Dr. | 1,60,000 | |
| Advance tax A/c | Dr. | 40,000 | |
| Cash and Bank A/c | Dr. | 2,60,000 | |
| To 12% Debenture holders A/c | | | 2,00,000 |
| To Creditors A/c | | | 90,000 |
| To Provision for Taxation A/c | | | [redacted] |
| To Business Purchase A/c | | | [redacted] |
| c. For Discharge of Purchase Consideration: | | | |
| Liquidator of Dinesh Ltd. | Dr. | 18,10,000 | |
| To Equity Share capital A/c | | | 4,48,010 |
| To Securities premium A/c | | | 13,61,950 |
| To Cash A/c | | | 40 |
| d. Contra Entry | | | |
| Amalgamation Adjustment A/c | Dr. | 80,000 | |
| To Export Profit Reserve A/c | | | 80,000 |

Name of the Company: Ramesh Ltd.

Balance Sheet as at 31.03.2013

| Ref No. | Particulars | Note No. | As at 31st March, 2013 ` | As at 31st March, 2012 ` |
|---|---|---|---|---|
| I. | Equity and Liabilities | | | |
| 1 | Shareholders' funds | | | |
| | (a) Share capital | 1 | 18,48,010 | |
| | (b) Reserves and surplus | 2 | 29,81,950 | |
| | (c) Money received against share warrants | | | |
| 2 | Share application money pending allotment | | | |
| 3 | Non-current liabilities | | | |

| | | | |
|---|---|---|---|
| | (a) Long-term borrowings | 3 | 4,00,000 |
| | (b)Deferred tax liabilities (Net) | | |
| | (c) Other Long term liabilities | | |
| | (d) Long-term provisions | | |
| 4 | Current Liabilities | | |
| | (a) Short-term borrowings | | |
| | (b) Trade payables | 4 | 1,70,000 |
| | (c) Other current liabilities | | |
| | (d) Short-term provisions | 5 | 3,20,000 |
| | Total (1+2+3+4) | | 57,19,960 |
| II. | Assets | | |
| 1 | Non-current assets | | |
| | (a) Fixed assets | | |
| | (i) Tangible assets | 6 | 27,00,000 |
| | (ii) Intangible assets | 7 | 7,60,000 |
| | (iii) Capital work-in-progress | | |
| | (iv) Intangible assets under development | | |
| | (b) Non-current investments | 8 | 5,00,000 |
| | (c) Deferred tax assets (Net) | | |
| | (d) Long-term loans and advances | 9 | 2,00,000 |
| | (e) Other non-current assets | 10 | 80,000 |
| 2 | Current assets | | |
| | (a) Current investments | | |
| | (b) Inventories | 11 | 3,40,000 |
| | (c) Trade receivables | 12 | 3,10,000 |
| | (d) Cash and cash equivalents | 13 | 8,09,960 |
| | (e) Short-term loans and advances | | |
| | (f) Other current assets | 14 | 20,000 |
| | Total (1+2) | | 57,19,960 |

Note to the Accounts:-

`

| Note 1. Share Capital | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Authorised, Issued, Subscribed and Paid up Share Capital 1,84,801 Equity Shares of `10 each (of which 44,801 shares were issued for consideration other than cash) | 18,48,010 | |
| Total | 18,48,010 | |

| Note 2. Reserves and Surplus | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Securities Premium | 13,61,950 | |
| General Reserve | 7,0[redacted] | |
| Profit and Loss A/c `4,20,000<br>Add: Proposed Dividend Cancelled `2,80,000 | 7,00,000 | |
| Export Profit reserve (1,40,000+80,000) | 2,20,000 | |
| Total | 29,81,950 | |

| Note 3. Long-term borrowings | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| 12% Debentures of `100 each (2,00,000+2,00,000) | 4,00,000 | |
| Total | 4,00,000 | |

| Note 4. Trade Payables | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Sundry Creditors (80,000 + 90,000) | 1,70,000 | |
| Total | 1,70,000 | |

| Note 5. Short term Provisions | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Provision for Tax (2,00,000 + 1,20,000) | 3,20,000 | |
| Total | 3,20,000 | |

| Note 6. Tangible Assets | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Sundry Fixed assets (19,00,000 + 8,00,000) | 27,00,000 | |
| Total | 27,00,000 | |

| Note 7. Intangible assets | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Goodwill | 7,60,000 | |
| Total | 7,60,000 | |

| Note 8. Noncurrent Investments | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Investment (4,00,000 + 1,00,000) | 5,00,000 | |
| Total | 5,00,000 | |

| Note 9. Long-term Loans and advances | As at 31st March, [redacted] | As at 31st [redacted] |
|---|---|---|
| Advance Tax (1,60,000 + 40,000) | 2,00,000 | |
| Total | 2,00,000 | |

| Note 10.Other Non-current assets | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Amalgamation Adjustment A/c | 80,000 | |
| Total | 80,000 | |

| Note 11. Inventories | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Stock (2,40,000 + 1,00,000) | 3,40,000 | |
| Total | 3,40,000 | |

| Note 12. Trade receivables | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Debtors (1,50,000 +1,60,000) | 3,10,000 | |
| Total | 3,10,000 | |

| Note 13. Cash and Cash Equivalents | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Cash and Bank balance (5,50,000 + 2,60,000 - 40) | 8,09,960 | |
| Total | 8,09,960 | |

| Note 14. Other Current Assets | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Preliminary Expenses | 20,000 | |
| Total | 20,000 | |

(c) **The following is the Extract Trial Balance of "Tarun Ltd". as on 30.09.2012: (Amount in `)**

| **Particulars** | | **Dr.** | **Cr.** |
|---|---|---|---|
| **11% Preference Shares of `10 each** | | | **2,00,000** |
| **20,000 Equity Shares of `10 each, fully paid** | | | **2,00,000** |
| **10,000 Equity Shares of ` 10 each, ` 7.50 paid** | | | **75,000** |
| **13% Debentures** | | | **3,00,000** |
| **Mortgage Loan** | | | **1,60,000** |
| **Bank Overdraft** | | [redacted] | [redacted] |
| **Creditors for Trade** | | [redacted] | [redacted] |
| **Arrears of Income tax (Assessments concluded in July 2004)** | | | |
| **Assessment Year 2010-2011 -** | **42,000** | | |
| **Assessment Year 2011-2012 -** | **10,000** | | **52,000** |
| **Land and Building** | | **2,40,000** | |
| **Sundry Current Assets** | | **7,90,000** | |
| **Profit & Loss Account** | | **77,000** | |
| **Debenture Issue expenses not written off** | | **4,000** | |
| **Total** | | **11,11,000** | **11,11,000** |

**Other Information**

- **Mortgage Loan was secured against Land and Buildings. Debentures were secured by a Floating Charge on all the other assets.**
- **The Company was unable to meet the payments and therefore the Debenture holders appointed a Receiver and this was followed by a resolution for Members Voluntary Winding Up.**
- **The Receiver for the Debenture holders brought the Land and Buildings to auction and realized `3,00,000. He also took charge of Sundry Assets of the value of `4,80,000 and realized `4,00,000.**
- **The Liquidator realized `2,00,000 on the sale of the balance of Sundry Current Assets.**
- **The Bank Overdraft was secured by a personal guarantee of two of the Directors of the Company and on the Bank raising a demand, the Directors paid off the dues from their personal resources.**
- **Costs incurred by the Receiver were ` 4,000 and by the Liquidator ` 5,600.**

- **The Receiver was not entitled to any remuneration but the Liquidator was to receive 3% Fee on the value of assets realized by him.**
- **Preference Shareholders had not been paid dividend for the period after 30.9.2010 and interest for the last half-year was due to Debenture holders.**

**From the above information, prepare the Liquidator's Receipts and Payments Account. [16]**

**Answer:**

Determination of Surplus received by Liquidator from Receiver

| Receipts | ` | Payments | ` |
|---|---|---|---|
| Land and Buildings | 3,00,000 | Debenture Interest (3,00,000 x 13% x 6/12) | 19,500 |
| Sundry Current Assets | 4,00,000 | Income Tax Arrears (42,000 + 10,000) | 52,000 |
| | | Expenses of Receiver Given | 4,000 |
| | | Mortgage Loan Given | 1,60,000 |
| | | Debenture holders Principal Amount | 3,00,000 |
| | | Balance Surplus handed over to [redacted] (b/f) | |
| Total | 7,00,000 | | 7,00,000 |

Liquidator's Receipts & Payments Account

| Receipts | ` | Payments | | ` |
|---|---|---|---|---|
| Surplus received from Receiver (WN 1) | 1,64,500 | Remuneration to Liquidator (2,00,000 x 3%) | | 6,000 |
| | | Cost of Liquidation | | 5,600 |
| Sundry Assets realized | 2,00,000 | Unsecured Creditors: | | |
| Calls on Contributories | 21,700 | - Trade Creditors | 64,000 | |
| - From 10,000 Partly Paid Shares at ` 2.17 per share (See WN 3 below) | | - Directors (for Bank Overdraft paid) | 60,000 | 1,24,000 |
| | | Preference Shareholders: | | |
| | | - Share Capital | 2,00,000 | |
| | | - Arrears of Dividend (2 yrs) | 44,000 | 2,44,000 |
| | | Equity Shareholders' Final Payment | | |
| | | - Return of money to holders of 20,000 Fully Paid Shares at ` 0.33 each | | 6,600 |
| Total | 3,86,200 | Total | | 3,86,200 |

Calls from Holders of Partly Paid Shares

| Particulars | | ` |
|---|---|---|
| a. | Total of Receipts before considering Call Money (1,64,500 + 2,00,000) | 3,64,500 |
| b. | Total Payments before final payment to Equity Shares (5,600 + 6,000 + 1,24,000 + 2,44,000) | 3,79,600 |
| c. | Deficit from above from Calls made on Equity Shares (a-b) | (15,100) |
| d. | Notional Call on 10,000 Partly Paid Shares at ` 2.50 each | 25,000 |
| e. | Surplus Cash Balance after Notional Call (comparing c and d) | 9,900 |
| f. | Number of Shares deemed fully paid (20,000 + 10,000) | 30,000 |
| g. | Hence, Refund on Fully Paid Shares ` 9,900 / 30,000 Shares (e ÷ f) | 33 paise |
| h. | Therefore, Required Call on Partly Paid Shares (2.50 – 0.33) | ` 2.17 |

# Section C

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

**(i) State the advantages of Social audit.**

**Answer:**

Advantages of Social audit

- Encourages community participation among different business entities.
- Ensures continuous efforts towards environmental protection and use of environment friendly production processes.
- Builds customer satisfaction and trust through ethical business practices.
- Promotes collective decision making and sharing responsibilities.
- Develops human resources by working towards improvement of workers' and the underprivileged persons' working/ living conditions.

**(ii) Explain the difference between a checklist and an Internal Control questionnaire.**

**Answer:**

Difference between a checklist and an Internal Control questionnaire

| S. No | Basis | Check List | Internal Control Questionnaire |
|---|---|---|---|

| | | | |
|---|---|---|---|
| a. | Point of Time | It is issued at the commencement of audit and reported back after completion of audit. | It can be issued at any point of time and reported back immediately. |
| b. | Issued To | It is issued to the audit staff to be followed by them during audit and reported back at completion. | It is issued to various people at different levels in the organization. |
| c. | Contents | It contains instructions to be followed by audit assistants. | It contains questions to be answered by the employees of the organization. |
| d. | Objective | It works as a guideline for audit staff so that no area remains unchecked | This is used to collect the information to know about the internal control system and evaluate the weaknesses therein. |

**(iii) Explain the difference between Test Check and Statistical Sampling.**

**Answer:**

Difference between Test Checking and Statistical Sampling

| S.No. | Basis | Test Checking | Statistical Sampling |
|---|---|---|---|
| a. | Selection | Selective transactions are verified. | Drawing a sample from a large number of transactions. |
| b. | Technique | No specific technique is used. | Statistical technique used is: selection on random basis. |
| c. | Subjective | It is subjective and depends upon the choice of the auditor. | It depends upon the statistical technique applied. |
| d. | Risk& Method | It involves more risk as there are no specific methods for test check. | It carries lesser risk and various statistical methods can be used at different times. |

**(iv) What types of analysis are covered by analytical procedures?**

**Answer:**

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

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

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

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

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

**(i) What are the matters should be considered by the auditor of the company while doing audit of Charitable Institutions? [8]**

**Answer:**

When conducting the audit of a charitable institution, the auditor should consider the following matters:

- The auditor should study the constitution of the charitable institution, f[redacted] is set up under the Societies Registration Act or as per section 25 of the [redacted] a trust.
- Obtain a list of members of the governing body. This will help the auditor in identifying whether any of the members of the governing body has any interest in the charitable institution.
- The auditor should obtain a copy of the budget sanctioned or the financial statement. This would enable him to acquaint himself with the different heads of income and expenditures of incomes and expenditures of the institution.
- Examination of the system of internal check, especially as regards the accounting of the amounts collected.
- Check that the amounts received towards income have been duly collected, received and deposited into the bank regularly and promptly.
- These institutions receive subscriptions and donations which form the major part of their collections. Therefore the auditor should check the following:
- The amount or the rate of the annual subscription.
- Any instructions given by the donors as to the specific utilization of donation.
- Adequacy of internal controls existing as regards unused receipt books, counter foils, etc.
- Where subscriptions are received in advance these should be properly dealt with in the accounts.
- Verify the amounts of legacies received by reference to correspondence with any figures and other available informations.
- Where the institution has made any investments or given loans, the amount of dividend and interest should be properly vouched with reference to the counterfoils or dividend warrants

received. It should be ensured that such loans or grants are given under proper authorizations.

- If some property is given or taken on rent, then the auditor should check the tenancy agreement, the rent slips and the authorized person for the collection or payment, as the case may be, of the rent.
- Most of the organisations organize special functions such as concert etc. The auditor should be careful in such cases. All the gross receipts and outgoings are to be properly vouched by him. It should be ensured that proper internal check was maintained as regards the receipts and outgoings. For example, the person responsible for collection and disbursements should be separate persons.
- The expenditure of charitable institution is also one of the major areas of concern. Thus the auditor should verify that the expenditure is made only for the charitable purpose. If the expenditure is not for the charitable purpose, then the auditor should examine the implications of applicable law and document for the same.
- The auditor should physically verify the cash in hand, inventories and fixed assets.

**(ii) What are the scope of Audit Committee of the company?**

**Answer:**

An Audit Committee consists of three to five members formed to serve as communication link among various departments. Audit Committee has a fourfold relationship and therefore has to interact with management, internal auditor, statutory auditor and the public.

The Scope of Audit Committee can be discussed as follows: -

- Review of annual financial statements before submission to the Board of Directors.
- Selection of the Statutory Auditor
- Act as lies on between the Statutory Auditor and Board of Directors
- Administrative control of the internal control functions through the feedback between the Internal Auditor and the Audit Committee.
- Over seeing internal central operation.
- Over seeing internal audit operations and feedback between internal audit committee and developing the internal auditing authority through broad based internal audit programming.
- Review and approval of financial information for publication
- Review proposed changes in accounting system and procedures.
- Help resolve differences between management, internal and statutory auditor.
- Report on the audit committee acting in the Annual Reports of Board of Directors.
- Ensure reliability of organisation's financial statements and operational activities. To be effective and purposeful, the audit committee should maintain the following:-

- Audit Committee should have the independence of management, Statutory Auditor and Internal Auditor. The Board of Directors allows full freedom to the audit committee to investigate into any areas of operation.
- The relation between the audit committee and management should be cordial and congenial towards optimum efficiency and healthy growth of the organization.
- There should be a regular line of communication through occasional meetings with the management.
- There should be good communication relationship interwoven among management, internal auditor and statutory auditor.

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

(a) **How to verify the following –** **[3x4 = 12]**
**(i) Verification of Contingent Liability**
**(ii) Verification of Plant & Machinery**
**(iii) Freehold Land & Building**

**Answer:**
(i) Verification of Contingent Liability

Auditor should carefully verify contingent liabilities as it may become actual liability on happening or not happening certain events and while verifying keep in mind following points.

- Obtain certificate about the contingent liabilities disclosed in the Balance Sheet, from a responsible officer.
- Carefully examine whether such liabilities are in existence or not.
- Check relevant documents to confirm the existence of contingent liability.
- Verify the certified list given by responsible officer to ascertain whether there exists any contingent liability which may turn to be an actual liability.
- Verify whether proper provision is made or not for the contingent liability turned out to be an actual liability.
- Verify bill discounting register, investment register, minute book and other relevant records to establish the amount of contingent liability.
- See whether contingent liability is properly disclosed in the Balance Sheet.

**(ii) Verification of Plant & Machinery**

As in case of industrial concern out of total assets 20% to 50% cost is that of Plant & Machinery and hence the auditor is required to take much more precaution while verifying the Plant and Machinery and for this he should give attention to following points-

- He should get the detailed list of all Plant and Machineries and asset wise accumulated depreciation.
- He should trace the opening balance in the Plant & Machinery register with the help of last year's audited balance sheet.

- He should verify quotations, invoices, cost etc., in connection with Purchase of Plant & Machinery. If there are sales of Plant & Machinery in audit period he should verify the invoice to that effect. He should check the Board Resolution authorizing Purchases of Plant & Machinery.
- If any machinery is disposed off and sold as scrap during the audit period, he should check the authorization and values report in that connection.
- He should check the rates and calculation of depreciation and ensure these are according to the provision of Section 205 of the Companies Act, 1956.
- He should check whether related expenses incurred on purchases of machinery are duly capitalized.
- He should check whether proper accounting of profit earned or loss suffered on Sale of Machinery, during the audit period, is done.
- If any machine is manufactured by the client itself, auditor should verify that capitalization of material, labor and other expenses is properly done.
- He should obtain from the Company management certificate about the verification of all items as required under CARO.
- He should scan the Plant register and physically inspect some of the major plants by visiting to the works.
- He should, finally, ensure appropriate disclosure of all information on the balance sheet as required by the Companies Act.
- He should obtain a certificate from the local auditor to that effect, if Plant and Machinery is kept abroad at a distant place.

**(iii) Freehold Land & Building**

- He should see that Freehold Land and Buildings are shown separately and not mixed with lease hold or other assets.
- He should see that separate accounts for land and for buildings are mentioned because on land usually no depreciation is provided.
- He should see that the balance shown on Balance Sheet is directly traceable from respective ledger account.
- He should examine the title deeds of the property and see that the asset is in the name of the client and in the free and fair possession of the client.
- He should examine that the title deed is genuine.
- The Purchases during the year be examined with the related correspondence, broker's note, auctioneer's note.
- In case of construction of the building auditor should examine the various certificates such as Builder's certificate, Contractor's certificates, Architect's certificate, Local authority certificate where needed.
- He should verify the sale, if a part of property has been sold during the period under audit.
- He should obtain a certificate from mortgagee if the property has been mortgaged and the deeds are with the mortgagee to verify the property.
- Land is not subject to depreciation but see that proper depreciation is provided on building as per the provision of Sec 205 of the Companies Act, 1956.

- See that the fluctuation in the value is not to be considered on Balance Sheet but if it has been considered then see that this is properly disclosed on Balance Sheet.
- Auditor should physically verify the existence of asset.

(b) **(i) Explain the features and Scope of an Internal Audit.** **[6]**

**Answer:**

Features of Internal Audit

- It is an independent appraisal activity within the organization.
- It can be conducted by the staff of the entity or by an independent professional appointed for that purpose.
- It is conducted for review of accounting, financial and other operations and controls established within an organization.
- It is conducted as a service to the organization and is not a part of the organization.
- It intends to furnish the analysis, appraisals, suggestions and information concerning the activities reviewed to the management.
- Internal auditing functions as a continuous effort for promoting effective control at cost reasonable cost.

Scope

The Institute of Internal Auditors defines scope of internal auditing as 'examination and evaluation of the adequacy and effectiveness of organisation's system of internal control and the quality of actual performance'. Therefore, internal auditing is concerned with an evaluation of both internal control as well as the quality of actual performance. According to the Institute, the scope of internal audit involves the following:

- Review the reliability and integrity of financial and operating information and the means to locate, identify, measure, classify and report such information.
- Appraise the economy and efficiency with which resources are employed.
- Review the systems established to ensure compliance with those policies, plans, procedures, laws and regulations which could have a significant effect and impact on operations and report, and should determine whether the organization is in compliance.
- Review the means of safeguarding assets and as appropriate verify the existence of such assets.
- Review operations or programs to ascertain whether results are consistent with established objectives and goals and whether the operations or programs are being carried out as planned.
- Internal auditing, therefore, is a function distinct from authorization and recording. It is concerned not only with examination of the transaction as recorded in the books of accounts but also with appraisal or procedure with a view to effecting change for better efficiency, where possible.

**(ii) What are the difference between Internal Audit and External Audit?** **[6]**

**Answer:**

Distinction between Internal Audit and External Audit

On accounting matters, the internal and external auditors operate mainly in the same field and they have a common interest in ascertaining that there is an effective system of internal control for presentation and detection of errors and frauds and to ensure that it is operating satisfactorily and that an adequate accounting system exists to provide the information necessary for preparing true and fair financial statements. There are some fundamental differences between the work of an internal auditor and that of an external auditor regarding the following:

- Appointment: The internal auditor is appointed by the management, generally the Directors and is responsible to them.
- The external or the statutory auditor is appointed according to the concerned statute. Generally, in case of company form of organization, the auditors are appointed by the shareholders in the annual general meeting.
- Scope: The extent of the work undertaken by the internal auditor is determined the management.
- The external auditor undertakes the area of the work which arises from the responsibilities placed on him by the governing statute.
- Approach: The internal auditor's approach is with a view to ensure that the accounting system is efficient, so that the accounting information presented to management throughout the period is accurate and discloses material facts.
- The external auditor's approach is governed by his responsibility to satisfy himself that the accounts to be presented to the shareholders show a true and fair view of the profit or loss for the financial period and of the company's state of affairs at the end of that period.
- Responsibility: The internal auditor's responsibility is to the management. It follows that the internal auditors, being a servant of the company, does not have independence of status.
- The external auditors, however, is responsible directly to the shareholders. Unlike the internal auditors, he is a representative of the shareholders and has independence of status.
- Objective: The main objective of internal audit is to ensure that the laid down policies, procedures and other internal control functions are functioning as designed.
- Whereas the objective of the external auditor is to express opinion and view to on financial statements whether those statements are showing true and fair view of the organisation.
- Independence: External auditor is more independent than internal auditor in the field of reporting.

Except these important differences, the work of both the internal auditor and the external auditor, on matters of accounting, is carried out largely by similar means, such as:

- Examination of the system of internal check, for both soundness and principle and effectiveness in operation.
- Examination and checking of accounting records and statements.
- Verification of assets and liabilities.
- Observations, inquiry, making of statistical comparisons and such other measures as may be judged necessary.

The wide experience of the external auditor may be of assistance to the internal auditor: while on the other side the latter's intimate acquaintance with business concern may be of help to the external auditors. Co-operation in planning of the respective auditors may save unnecessary works, although the external auditors must always satisfy himself as to the work carried out by the internal auditors.

**(c) (i) On the audit of Dreamlight Ltd. the audit partner of the engagement set the preliminary level of audit materiality at `12,00,000. After, the partner reviewed the audit of senior's assessment of inherent risk, he decided that the materiality level should be increased to `18,00,000.**

**Required:**

**A. What is the relationship between materiality and audit risk?**

**B. How will this new level of materiality affect the nature and extent of auditing procedures? [8]**

**Answer:**

**A.** The relationship between materiality and audit risk:

The concept of materiality is applied by the auditor both in planning and [redacted] and in evaluating the effect of identified misstatements on the audit [redacted] misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

In planning the audit, the auditor makes judgments about the size of misstatements that will be considered material. These judgments provide a basis for:

- Determining the nature, timing and extent of risk assessment procedures;
- Identifying and assessing the risks of material misstatement; and
- Determining the nature, timing and extent of further audit procedures.

In conducting an audit of financial statements, the overall objectives of the auditor are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and to report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings. The auditor obtains reasonable assurance by obtaining sufficient appropriate audit evidence to reduce audit risk to an acceptably low level. Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk. Materiality and audit risk are considered throughout the audit, in particular, when:

- Identifying and assessing the risks of material misstatement;
- Determining the nature, timing and extent of further audit procedures; and
- Evaluating the effect of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

**B.** The auditor shall revise materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) in the event of becoming aware of information during the audit that would have

caused the auditor to have determined a different amount (or amounts) initially (Initially `12,00,000 and revised at `18,00,000).

If the auditor concludes that a lower materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) than that initially determined is appropriate, the auditor shall determine whether it is necessary to revise performance materiality, and whether the nature, timing and extent of the further audit procedures remain appropriate.

Materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) may need to be revised as a result of a change in circumstances that occurred during the audit (for example, a decision to dispose of a major part of the entity's business), new information, or a change in the auditor's understanding of the entity and its operations as a result of performing further audit procedures. For example, if during the audit it appears as though actual financial results are likely to be substantially different from the anticipated period end financial results that were used initially to determine materiality for the financial statements as a whole, the auditor revises that materiality.

**(ii) Explain the difference between Qualified Report and Adverse Report. [4]**

**Answer:**

Distinguish Between Qualified Report and Adverse Report

| | Qualified Report | Adverse Report |
|---|---|---|
| i. | A Qualified Audit Report is one an Auditor gives an opinion subject to certain reservations. | An Adverse Report is given when the concludes that based on his examination, he does not agree with the affirmations made in the Financial Statements / Financial Report. |
| ii. | The Auditor's reservation is generally Stated as: "Subject to the above, we report that the Balance Sheet shows a true and fair view." | The Auditor states that the Financial Statements do not present a true and fair view of the state of affairs and working results of the organisation. |
| iii. | The accounts present a true and fair view subject to certain reservations. | The accounts do not present a true and fair view on the whole. |
| iv. | A Qualification is made in the Audit Report when the Auditor has reservation on specific item(s) of material nature. | An Adverse Report is given when the Auditor has his reservations on the true and fair view presented by the Financial Statements. |

# Paper 12 - Company Accounts & Audit

**Full Marks: 100**

# Section A

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

**(i) Differentiate between Reporting Currency and Foreign Currency.**

**Answer:**

Difference between Reporting Currency and Foreign Currency

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

**(ii) Define Financial Assets and Financial Liability as per AS 20.**

**Answer:**

Financial Asset: A Financial Asset is any asset that is –
(a) Cash
(b) A contractual right to receive cash or another Financial Asset from another Enterprise,
(c) A contractual right to exchange Financial Instruments with another Enterprise, under conditions that are potentially favorable, or
(d) An Equity Share of another Enterprise.

Financial Liability: A Financial Liability is any liability that is a contractual obligation –
(a) To deliver cash or another Asset to another Enterprise, or
(b) To exchange Financial Instruments with another Enterprise, under conditions that are potentially unfavourable.

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

**(a) Explain the objective of Financial Statements. [8]**

**Answer:**

Objective of Financial Statements

The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions. This would guide in deciding statements, their contents and disclosures.

A set of general purpose financial statements focus on financial position, performance and cash flows of an entity which could be used by any user group to assess investment decision,

employment stability or growth, debt servicing, business continuity and ability to make societal contribution. General purpose financial statements are those intended to meet the needs of users who are not in a position to require an entity to prepare reports tailored to their particular information needs.

A complete set of financial statements as worked out in Para 10 of IAS 1 is the outcome of the Framework which in turn is linked to subserve the information need of various user-groups. It comprises of:

(i) a statement of financial position as at the end of the period;

(ii) a statement of comprehensive income for the period ;

(iii) a statement of changes in equity for the period;

(iv) a statement of cash flows for the period;

(v) notes, comprising a summary of significant accounting policies and other explanatory information; and

(vi) a statement of financial position as at the beginning of the earliest comparative period when an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements.

Notes, comprising a summary of significant accounting policies and other explanatory information are important components of financial statements as they explain various elements of financial statements. Disclosure of risks adds to the information content of the financial statements.

Earning per share information contained in the Income Statement is focused information to shareholders as regards entity's performance. Information regarding diluted earning improves the information communique working out the effect of possible equity dilution actions. Similarly, segment reporting is intended to provide disaggregated information based on operating and / or geographic segments, consolidated financial statements focus on providing aggregated financial information for the entity-group as a whole, related party disclosures are intended to highlight non-market oriented transactions, if any. Thus the origination and improvement in disclosure and presentation standards have the purpose of making a set of general purpose financial statements useful to the diverse user-groups.

**(b) (i) Compute Basic Earnings Per Share from the following information –**

| **Date** | **Particulars** | **No. of Shares** |
|---|---|---|
| **1st April 2011** | **Balance at the beginning of the year** | **1,500** |
| **1st August 2011** | **Issue of Shares for Cash** | **600** |
| **31st March 2012** | **Buy back of Shares** | **500** |

**Net Profit for year ended 31st March 2012 was `2,75,000.** **[4]**

**Answer:**

1. Computation of Weighted Average Number of Shares outstanding during the period

| Date | No. of Equity share | Period Outstanding | Time Weighting factor | Weighted Avg. No. of Shares |
|---|---|---|---|---|
| (1) | (2) | (3) | (4) | (5)= (2) x (4) |
| 1st April 2011 | (Opening) 1,500 | 12 months | 12/12 | 1,500 |
| 1st August 2011 | (Fresh Issue) 600 | 8 months | 8/12 | 400 |
| 31st March 2012 | (Buy Back) 500 | 0 Months | 0/12 | - |

| | |
|---|---|
| Weighted average Number of Equity Shares Outstanding during the period | 1,900 |

2. Basic EPS = $\dfrac{\text{Net Profit or Loss attributable to Equity Shareholders}}{\text{Weighted Average Number of Equity shares Outstanding}}$

$= \dfrac{\text{` } 2{,}75{,}000}{1{,}900 \text{ Shares}} = \text{`}144.74$ per Share.

**(ii) Discuss the accounting treatment for Operating Leases in the Financial statements of Lessor. [4]**

**Answer:**

(a) Asset Recognition: The Lessor should present an Asset given under Operating Lease in its Balance Sheet under Fixed Assets.
(b) Income Recognition: Lease Income (excluding receipts for services provided, e.g. insurance and maintenance), should be recognised in the Statement of Profit and Loss on a Straight Line Basis over the Lease Term, even if it is not received on that basis, unless another systematic basis is more representative of the time pattern in which benefit derived from the use of the leased asset is diminished.
(c) Cost Recognition: Costs, including Depreciation, incurred in earning the Lease Income are recognised as an Expense.
(d) Initial Direct Costs: Initial Direct Costs incurred specifically to earn revenues are either - (a) deferred and allocated to income over the lease term in proportion [redacted] Rent Income, or (b) are recognised as an Expense in the Statement [redacted] period in which they are incurred.
(e) Depreciation: Depreciation of Leased Assets should be on a basis consistent with the normal depreciation policy of the Lessor for similar assets. The Depreciation charge should be calculated on the basis set out in AS - 6.
(f) Impairment Losses: The Lessor should apply AS - 28 to determine whether a Leased Asset has become impaired, and treat such impairment accordingly.
(g) Selling Profit: A Manufacturer or Dealer Lessor does not recognise any Selling Profit on entering into an Operating Lease, because it is not the equivalent of a sale.

**(c) Write short notes on recognition of Past Service Cost. [8]**

**Answer:**

1. Recognition as Expense:
   (a) In measuring its Defined Benefit Liability under Para 55, an Enterprise should recognise Past Service Cost as an expense, on a straight-line basis over the average period until the benefits become vested.
   (b) To the extent that the benefits are already vested immediately following the introduction of, or changes to, a Defined Benefit Plan, an enterprise should recognise Past Service Cost immediately.

   Example:

   An Enterprise operates a pension plan that provides a pension of 2% of final salary for each year of service. The benefits become vested after 5 years of service. On 1st January 20X4, the Enterprise improves the pension to 2.5% of final salary for each year of service starting from 1st January 20X0.

   Suppose, at the date of the improvement, the PV of the additional benefits for service from 1st Jan 20X0 to 1st January 20X4 is as follows -

| | |
|---|---|
| Employees with more than 5 years' service at 01.01.20X4 | `150 |
| Employees with less than 5 years' service at 01.01.20X4 | `120 |
| (Average period until vesting: 3 years) | |
| | `270 |

In this case, the Enterprise should recognise `150 immediately because those benefits are already vested. The Enterprise should recognise `120 on a straight-line basis over 3 years from 1st January 20X4.

2. Amendment of Amortisation Schedule: An Enterprise establishes the amortisation schedule for Past Service Cost when the benefits are introduced or changed. It would be impracticable to maintain the detailed records needed to identify and implement subsequent changes in that amortisation schedule. Also, the effect is likely to be material only where there is a curtailment or settlement. So, an Enterprise should amend the amortisation schedule for Past Service Cost, only if there is a curtailment or settlement.
3. Negative Past Service Cost: Where an Enterprise reduces benefits payable under an existing Defined Benefit Plan, the resulting reduction in the Defined Benefit Liability is recognised as (negative) Past Service Cost over the average period, until the reduced portion of the benefits becomes vested.
4. Net Change: Where an Enterprise reduces certain benefits payable under an existing Defined Benefit Plan and, at the same time, increases other benefits payable under the plan for the same employees, the Enterprise treats the change as a single net change.

# Section B

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

**(i) Explain the disclosure requirement of Deferred tax assets.**

**Answer:**

Deferred Tax Asset - Disclosure requirement

To be shown as a separate line item on the face of Balance Sheet.

**(ii) Explain the disclosure requirement of Intangible assets under development.**

**Answer:**

Intangible Assets under Development - Disclosure requirement

To be shown as a separate line item on the face of Balance Sheet.

Note - Intangible Assets under development should be disclosed under this head provided they can be recognized based on the criteria laid down in AS-26.

**(iii) What is meant by List B of Contributories?**

**Answer:**

a) Persons: Shareholders who had transferred Partly Paid Shares (otherwise than by operation of law or by death) within one year, prior to the date of winding up may be called upon to pay an

amount to pay off such Creditors as existed on the date of transfer of shares. These Transferors are called as B List Contributories.

b) Liability: Their liability is restricted to the amount not called up when the shares were transferred. They cannot be called upon to pay more than the entire face value of the share. For example, if Shares having Face Value of `100 were paid up `60, the B List Contributory can be called up to pay a maximum of `40 only.

c) Conditions: Liability of B List Contributories will crystallize only (a) when the existing assets available with the liquidator are not sufficient to cover the liabilities; (b) when the existing shareholders fail to pay the amount due on the shares to the Liquidator.

**(iv) What are the disclosure requirements of reportable segment under AS 17?**

**Answer:**

An enterprise should disclose the following for each reportable segment:

(a) segment revenue, classified into segment revenue from sales to external customers and segment revenue from transactions with other segments;

(b) segment result;

(c) total carrying amount of segment assets;

(d) total amount of segment liabilities;

(e) total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (tangible and intangible fixed assets);

(f) total amount of expense included in the segment result for depreciation and amortisation in respect of segment assets for the period; and

(g) total amount of significant non-cash expenses, other than depreciation and amortisation in respect of segment assets, that were included in segment expense and, therefore, deducted in measuring segment result.

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

**(a) On 1st April 2009, Gravity Ltd. issued 442, 10% Debentures of ` 1000 each at a discount of 10% redeemable at a premium of 5% after 4 years. It was decided to create a Sinking Fund for the purposes of accumulating sufficient funds to redeem the Debentures and to invest in some radily convertible securities yielding 10% interest p.a. Reference to the table shows that `1.00 p.a. at 10% compound interest amounts to `4.641 in 4 years. Investments are to be made in the Bonds of `1000 each available at par.**

**On 31st March 2013, the investments realised `3,40,000 and debentures were redeemed. The bank balance as on that date was `50,000.**

**Required: Prepare Debenture Redemption Fund Account and Debenture Redemption Fund Investments Account for 4 years. [16]**

**Answer:**

DRF = Debenture Redemption Fund, DRFI = Debenture Redemption Fund Investment

Dr. Discount on Issue of Debentures Account Cr.

| Date | Particulars | ` | Date | Particulars | ` |
|---|---|---|---|---|---|
| 31.03.10 | To Balance c/d | 1,00,000 | 31.03.10 | By P & L App. A/c | 1,00,000 |
| 31.03.11 | To Balance c/d | 2,10,000 | 01.04.10 | By Balance b/d | 1,00,000 |
| | | | 31.03.11 | By Interest on DRFI A/c | 10,000 |
| | | | | By P & L App. A/c | 1,00,000 |
| | | 2,10,000 | | | 2,10,000 |
| 31.03.12 | To Balance c/d | 3,31,000 | 01.04.11 | By Balance b/d | 2,10,000 |
| | | | | By Interest on DRFI A/c | 21,000 |
| | | | | By P & L App. A/c | 1,00,000 |
| | | 3,31,000 | | | 3,31,000 |
| 31.03.13 | To Loss on issue of Debentures (premium) | 22,100 | 01.04.12 | By Balance b/d | 3,31,000 |
| | To Debenture Redemption Reserve A/c | 4,52,000 | | By Interest on DRFI A/c | 33,100 |
| | | | | By P & L App. A/c | 91,000 |
| | | | | By Debenture [redacted] Investment A/c [redacted] | |
| | | 4,74,100 | | | 4,74,100 |

Dr. Debentures Redemption Fund Investment (DRFI) Account Cr.

| Date | Particulars | ` | Date | Particulars | ` |
|---|---|---|---|---|---|
| 31.03.10 | To Bank A/c | 1,00,000 | 31.03.10 | By Balance c/d | 1,00,000 |
| 01.04.10 | To Balance b/d | 1,00,000 | 31.03.11 | By Balance c/d | 2,10,000 |
| 31.03.11 | To Bank A/c | 1,10,000 | | | |
| | | 2,10,000 | | | 2,10,000 |
| 01.04.11 | To Balance b/d | 2,10,000 | 31.03.12 | By Balance c/d | 3,31,000 |
| 31.03.12 | To Bank A/c | 1,21,000 | | | |
| | | 3,31,000 | | | 3,31,000 |
| 01.04.12 | To Balance b/d | 3,31,000 | 31.03.13 | By Bank A/c (Sales) | 3,50,000 |
| 31.03.13 | To Debenture Redemption Fund A/c (Profit) | 9,000 | | | |
| | | 3,50,000 | | | 3,50,000 |

**Working Note:**

(i) Calculation of the amount of profit set aside

| | | ` |
|---|---|---|
| a. | Face Value of Debentures | 4,42,000 |

| | | |
|---|---|---|
| b. | Premium Payable on Redemption | 22,100 |
| c. | Depreciable Cost (A + B) | 4,64,100 |
| d. | Value of annuity per `1 | 4,641 |
| e. | Annual amount to be charged (C/D) | 1,00,000 |

(ii) Calculation of the amount of investments and interest

| Year | Opening Balance | Interest | Saving | Investments | Closing Balance |
|---|---|---|---|---|---|
| a | b | c = b×10/100 | d | e = c + d | f = b + e |
| 2009-10 | — | — | 1,00,000 | 1,00,000 | 1,00,000 |
| 2010-11 | 1,00,000 | 10,000 | 1,00,000 | 1,10,000 | 2,10,000 |
| 2011-12 | 2,10,000 | 21,000 | 1,00,000 | 1,21,000 | 3,31,000 |
| 2012-13 | 3,31,000 | 33,100 | 1,00,000 | — | — |

**(b) Given below is the Extract Trial Balance of Ramesh Ltd. and Dinesh Ltd. as on 31.3.2013. Dinesh Ltd. was merged with Ramesh Ltd. with effect from 01.04.2013.**

**Trial Balance (Extract) as on 31.3.2013** **(`)**

| **Particulars** | **Ramesh Ltd.** | | **Dinesh Ltd.** | |
|---|---|---|---|---|
| | **Dr.** | **Cr.** | **Dr.** | **Cr.** |
| **Equity Shares of ` 10 each** | | **14,00,000** | | **5,00,000** |
| **General Reserve** | | **7,00,000** | | **2,40,000** |
| **Profit and Loss A/c** | | **4,20,000** | | **1,30,000** |
| **Export Profit Reserve** | | **1,40,000** | | **80,000** |
| **12% Debentures** | | **2,00,000** | | **2,00,000** |
| **Sundry Creditors** | | **80,000** | | **90,000** |
| **Provision for Taxation** | | **2,00,000** | | **1,20,000** |
| **Proposed Dividend** | | **2,80,000** | | **1,00,000** |
| **Sundry Fixed Assets (Tangible)** | **19,00,000** | | **8,00,000** | |
| **Investments (Non-trade)** | **4,00,000** | | **1,00,000** | |
| **Stock (opening)** | **2,40,000** | | **1,00,000** | |
| **Debtors** | **1,50,000** | | **1,60,000** | |
| **Advance Tax** | **1,60,000** | | **40,000** | |
| **Cash and Bank balances** | **5,50,000** | | **2,60,000** | |
| **Preliminary Expenses** | **20,000** | | | |
| **Total** | **34,20,000** | **34,20,000** | **14,60,000** | **14,60,000** |

**Closing Stock of Ramesh and Dinesh is also `2,40,000 & `1,00,000 respectively. Ramesh Ltd. would issue 12% Debentures to discharge the claims of the debenture holders of Dinesh Ltd. at par. Non-trade investments of Ramesh Ltd. fetched @ 25% while those of Dinesh Ltd. fetched @ 18%.**

**Profit (pre-tax) by Ramesh Ltd and Dinesh Ltd. during 2010-11, 2011-12 and 2012-13 and were as follows:**

| **Year** | **Ramesh Ltd.** | **Dinesh Ltd.** |
|---|---|---|
| | ` | ` |
| **2010-11** | **10,00,000** | **3,00,000** |
| **2011-12** | **13,00,000** | **4,20,000** |
| **2012-13** | **11,50,000** | **3,60,000** |

**Goodwill may be calculated on the basis of capitalisation method taking 20% as the pre-tax normal rate of return. Purchase consideration is discharged by Ram Ltd. on the basis of intrinsic value per share. Both companies decided to cancel the proposed dividend.**

**Required: Balance Sheet of Ramesh Ltd. after merger.** **[16]**

**Answer:**

WN # 1: Purchase Consideration:

| | | |
|---|---|---|
| (i) | Shares outstanding in Dinesh Ltd. | 50,000 |
| (ii) | Intrinsic Value per Share of Dinesh Ltd. [WN # 2] | ` 36.20 |
| (iii) | Value of Shares (a × b) | ` 18,10,000 |
| (iv) | Intrinsic value per share of Ramesh Ltd. [WN # 2] | ` 40.40 |
| (v) | No. of shares to be issued by Ramesh Ltd. | |

` 18,10,000/ ` 40.40 = 44,801.99

| Shares | Cash for fractions |
|---|---|
| 44,801 | 0.99 × 40.40 = 40 |

(iv) Purchase consideration

| | | |
|---|---|---|
| (a) 44,801 shares @ 40.40 | | |
| Capital [`10 / Share] | 4,48,010 | |
| Premium [`30.40 / Share] | 13,61,950 | = 18,09,960 |
| (b) Cash for fractional shares | | = 40 |
| (c) Total purchase consideration payable | | = 18,10,000 |

WH # 2: Intrinsic Value per share:

(`)

| | | | Ramesh Ltd. | | Dinesh Ltd. | |
|---|---|---|---|---|---|---|
| (i) | | Assets | | | | |
| | (a) | Goodwill | 27,30,000 | | 7,60,000 | |
| | (b) | Sundry Fixed assets | 19,00,000 | | 8,00,000 | |
| | (c) | Investments | 4,00,000 | | 1,00,000 | |
| | (d) | Stock | 2,40,000 | | 1,00,000 | |
| | (e) | Debtors | 1,50,000 | | 1,60,000 | |
| | (f) | Advance Tax | 1,60,000 | | 40,000 | |
| | (g) | Cash and Bank Balance | 5,50,000 | 61,30,000 | 2,60,000 | 22,20,000 |
| (ii) | | Liabilities | | | | |
| | (a) | 12% Debentures | 2,00,000 | | 2,00,000 | |

| | | | | | |
|---|---|---|---|---|---|
| | (b) Sundry creditors | 80,000 | | 90,000 | |
| | (c) Provision for tax | 2,00,000 | (4,80,000) | 1,20,000 | (4,10,000) |
| (iii) | Net Assets (i-ii) | | 56,50,000 | | 18,10,000 |
| (iv) | No. of Outstanding Shares | | 1,40,000 | | 50,000 |
| (v) | Intrinsic Value per share (iii)/(iv) | | 40.40 | | 36.20 |

W # 3: Valuation of Goodwill

A. Capital Employed

| | | | Ramesh Ltd. | | Dinesh Ltd. |
|---|---|---|---|---|---|
| (i) | Assets: | | | | |
| | (a) Sundry Fixed assets | 19,00,000 | | 8,00,000 | |
| | (b) Investment (Non-trade) | - | | - | |
| | (c) Stock | 2,40,000 | | 1,00,000 | |
| | (d) Debtors | 1,50,000 | | 1,60,000 | |
| | (e) Advance tax | 1,60,000 | | 40,000 | |
| | (f) Cash and Bank balance | 5,50,000 | 30,00,000 | 2,60,000 | 13,60,000 |
| (ii) | Liabilities: | | | | |
| | (a) 12% Debentures | 2,00,000 | | [redacted] | |
| | (b) Sundry creditors | 80,000 | | 90,000 | |
| | (c) Provision for tax | 2,00,000 | 4,80,000 | 1,20,000 | 4,10,000 |
| (iii) | Capital Employed: (i) - (ii) | | 25,20,000 | | 9,50,000 |

B. Average Pre-tax Profit:

| Particulars | | Ramesh Ltd. | Dinesh Ltd. |
|---|---|---|---|
| (i) | 2010-11 | 10,00,000 | 3,00,000 |
| (ii) | 2011-12 | 13,00,000 | 4,20,000 |
| (iii) | 2012-13 | 11,50,000 | 3,60,000 |
| (iv) | Total (a+b+c) | 34,50,000 | 10,80,000 |
| (v) | Simple Average [(iv)/3] | 11,50,000 | 3,60,000 |
| (vi) | Less: Non-trading income | (1,00,000) | (18,000) |
| (vii) | Average pre-tax profit | 10,50,000 | 3,42,000 |

C. Computation of Goodwill:

| Particulars | | Ramesh Ltd. | Dinesh Ltd. |
|---|---|---|---|
| | | ` | ` |
| a. | Capitalised value of average profits $\frac{10,50,000}{0.20};\frac{3,42,000}{0.20}$ | 52,50,000 | 17,10,000 |
| b. | Capital Employed | 25,20,000 | 9,50,000 |
| c. | Goodwill (a-b) | 27,30,000 | 7,60,000 |

Journal Entries - Books of Ramesh Ltd.

- Nature of Amalgamation – PURCHASE
- Method of Accounting – PURCHASE METHOD

| Particulars | | Debit | Credit |
|---|---|---|---|
| a. For Business Purchase : | | | |
| Business Purchase A/c | Dr. | 18,10,000 | |
| To Liquidator of Dinesh Ltd. A/c | | | 18,10,000 |
| b. For Assets and Liabilities taken over | | | |
| Goodwill A/c | Dr. | 7,60,000 | |
| Fixed Assets A/c | Dr. | 8,00,000 | |
| Investments A/c | Dr. | 1,00,000 | |
| Stock A/c | Dr. | 1,00,000 | |
| Debtors A/c | Dr. | 1,60,000 | |
| Advance tax A/c | Dr. | 40,000 | |
| Cash and Bank A/c | Dr. | 2,60,000 | |
| To 12% Debenture holders A/c | | | 2,00,000 |
| To Creditors A/c | | | 90,000 |
| To Provision for Taxation A/c | | | [redacted] |
| To Business Purchase A/c | | | [redacted] |
| c. For Discharge of Purchase Consideration: | | | |
| Liquidator of Dinesh Ltd. | Dr. | 18,10,000 | |
| To Equity Share capital A/c | | | 4,48,010 |
| To Securities premium A/c | | | 13,61,950 |
| To Cash A/c | | | 40 |
| d. Contra Entry | | | |
| Amalgamation Adjustment A/c | Dr. | 80,000 | |
| To Export Profit Reserve A/c | | | 80,000 |

Name of the Company: Ramesh Ltd.

Balance Sheet as at 31.03.2013

| Ref No. | Particulars | Note No. | As at 31st March, 2013 ` | As at 31st March, 2012 ` |
|---|---|---|---|---|
| I. | Equity and Liabilities | | | |
| 1 | Shareholders' funds | | | |
| | (a) Share capital | 1 | 18,48,010 | |
| | (b) Reserves and surplus | 2 | 29,81,950 | |
| | (c) Money received against share warrants | | | |
| 2 | Share application money pending allotment | | | |
| 3 | Non-current liabilities | | | |

| | | | |
|---|---|---|---|
| | (a) Long-term borrowings | 3 | 4,00,000 |
| | (b)Deferred tax liabilities (Net) | | |
| | (c) Other Long term liabilities | | |
| | (d) Long-term provisions | | |
| 4 | Current Liabilities | | |
| | (a) Short-term borrowings | | |
| | (b) Trade payables | 4 | 1,70,000 |
| | (c) Other current liabilities | | |
| | (d) Short-term provisions | 5 | 3,20,000 |
| | Total (1+2+3+4) | | 57,19,960 |
| II. | Assets | | |
| 1 | Non-current assets | | |
| | (a) Fixed assets | | |
| | (i) Tangible assets | 6 | 27,00,000 |
| | (ii) Intangible assets | 7 | 7,60,000 |
| | (iii) Capital work-in-progress | | |
| | (iv) Intangible assets under development | | |
| | (b) Non-current investments | 8 | 5,00,000 |
| | (c) Deferred tax assets (Net) | | |
| | (d) Long-term loans and advances | 9 | 2,00,000 |
| | (e) Other non-current assets | 10 | 80,000 |
| 2 | Current assets | | |
| | (a) Current investments | | |
| | (b) Inventories | 11 | 3,40,000 |
| | (c) Trade receivables | 12 | 3,10,000 |
| | (d) Cash and cash equivalents | 13 | 8,09,960 |
| | (e) Short-term loans and advances | | |
| | (f) Other current assets | 14 | 20,000 |
| | Total (1+2) | | 57,19,960 |

Note to the Accounts:-

`

| Note 1. Share Capital | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Authorised, Issued, Subscribed and Paid up Share Capital 1,84,801 Equity Shares of `10 each (of which 44,801 shares were issued for consideration other than cash) | 18,48,010 | |
| Total | 18,48,010 | |

| Note 2. Reserves and Surplus | | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|---|
| Securities Premium | | 13,61,950 | |
| General Reserve | | 7,0[illegible] | |
| Profit and Loss A/c | `4,20,000 | | |
| Add: Proposed Dividend Cancelled | `2,80,000 | 7,00,000 | |
| Export Profit reserve (1,40,000+80,000) | | 2,20,000 | |
| Total | | 29,81,950 | |

| Note 3. Long-term borrowings | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| 12% Debentures of `100 each (2,00,000+2,00,000) | 4,00,000 | |
| Total | 4,00,000 | |

| Note 4. Trade Payables | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Sundry Creditors (80,000 + 90,000) | 1,70,000 | |
| Total | 1,70,000 | |

| Note 5. Short term Provisions | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Provision for Tax (2,00,000 + 1,20,000) | 3,20,000 | |
| Total | 3,20,000 | |

| Note 6. Tangible Assets | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Sundry Fixed assets (19,00,000 + 8,00,000) | 27,00,000 | |
| Total | 27,00,000 | |

| Note 7. Intangible assets | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Goodwill | 7,60,000 | |
| Total | 7,60,000 | |

| Note 8. Noncurrent Investments | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Investment (4,00,000 + 1,00,000) | 5,00,000 | |
| Total | 5,00,000 | |

| Note 9. Long-term Loans and advances | As at 31st March, [redacted] | As at 31st [redacted] |
|---|---|---|
| Advance Tax (1,60,000 + 40,000) | 2,00,000 | |
| Total | 2,00,000 | |

| Note 10.Other Non-current assets | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Amalgamation Adjustment A/c | 80,000 | |
| Total | 80,000 | |

| Note 11. Inventories | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Stock (2,40,000 + 1,00,000) | 3,40,000 | |
| Total | 3,40,000 | |

| Note 12. Trade receivables | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Debtors (1,50,000 +1,60,000) | 3,10,000 | |
| Total | 3,10,000 | |

| Note 13. Cash and Cash Equivalents | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Cash and Bank balance (5,50,000 + 2,60,000 - 40) | 8,09,960 | |
| Total | 8,09,960 | |

| Note 14. Other Current Assets | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Preliminary Expenses | 20,000 | |
| Total | 20,000 | |

(c) **The following is the Extract Trial Balance of "Tarun Ltd". as on 30.09.2012: (Amount in `)**

| **Particulars** | | **Dr.** | **Cr.** |
|---|---|---|---|
| **11% Preference Shares of `10 each** | | | **2,00,000** |
| **20,000 Equity Shares of `10 each, fully paid** | | | **2,00,000** |
| **10,000 Equity Shares of ` 10 each, ` 7.50 paid** | | | **75,000** |
| **13% Debentures** | | | **3,00,000** |
| **Mortgage Loan** | | | **1,60,000** |
| **Bank Overdraft** | | | [redacted] |
| **Creditors for Trade** | | | [redacted] |
| **Arrears of Income tax (Assessments concluded in July 2004)** | | | |
| **Assessment Year 2010-2011 -** | **42,000** | | |
| **Assessment Year 2011-2012 -** | **10,000** | | **52,000** |
| **Land and Building** | | **2,40,000** | |
| **Sundry Current Assets** | | **7,90,000** | |
| **Profit & Loss Account** | | **77,000** | |
| **Debenture Issue expenses not written off** | | **4,000** | |
| **Total** | | **11,11,000** | **11,11,000** |

**Other Information**

- **Mortgage Loan was secured against Land and Buildings. Debentures were secured by a Floating Charge on all the other assets.**
- **The Company was unable to meet the payments and therefore the Debenture holders appointed a Receiver and this was followed by a resolution for Members Voluntary Winding Up.**
- **The Receiver for the Debenture holders brought the Land and Buildings to auction and realized `3,00,000. He also took charge of Sundry Assets of the value of `4,80,000 and realized `4,00,000.**
- **The Liquidator realized `2,00,000 on the sale of the balance of Sundry Current Assets.**
- **The Bank Overdraft was secured by a personal guarantee of two of the Directors of the Company and on the Bank raising a demand, the Directors paid off the dues from their personal resources.**
- **Costs incurred by the Receiver were ` 4,000 and by the Liquidator ` 5,600.**

- **The Receiver was not entitled to any remuneration but the Liquidator was to receive 3% Fee on the value of assets realized by him.**
- **Preference Shareholders had not been paid dividend for the period after 30.9.2010 and interest for the last half-year was due to Debenture holders.**

**From the above information, prepare the Liquidator's Receipts and Payments Account. [16]**

**Answer:**

Determination of Surplus received by Liquidator from Receiver

| Receipts | ` | Payments | ` |
|---|---|---|---|
| Land and Buildings | 3,00,000 | Debenture Interest (3,00,000 x 13% x 6/12) | 19,500 |
| Sundry Current Assets | 4,00,000 | Income Tax Arrears (42,000 + 10,000) | 52,000 |
| | | Expenses of Receiver Given | 4,000 |
| | | Mortgage Loan Given | 1,60,000 |
| | | Debenture holders Principal Amount | 3,00,000 |
| | | Balance Surplus handed over to [redacted] (b/f) | |
| Total | 7,00,000 | | 7,00,000 |

Liquidator's Receipts & Payments Account

| Receipts | ` | Payments | | ` |
|---|---|---|---|---|
| Surplus received from Receiver (WN 1) | 1,64,500 | Remuneration to Liquidator (2,00,000 x 3%) | | 6,000 |
| | | Cost of Liquidation | | 5,600 |
| Sundry Assets realized | 2,00,000 | Unsecured Creditors: | | |
| Calls on Contributories | 21,700 | - Trade Creditors | 64,000 | |
| - From 10,000 Partly Paid Shares at ` 2.17 per share (See WN 3 below) | | - Directors (for Bank Overdraft paid) | 60,000 | 1,24,000 |
| | | Preference Shareholders: | | |
| | | - Share Capital | 2,00,000 | |
| | | - Arrears of Dividend (2 yrs) | 44,000 | 2,44,000 |
| | | Equity Shareholders' Final Payment | | |
| | | - Return of money to holders of 20,000 Fully Paid Shares at ` 0.33 each | | 6,600 |
| Total | 3,86,200 | Total | | 3,86,200 |

Calls from Holders of Partly Paid Shares

| | Particulars | ` |
|---|---|---|
| a. | Total of Receipts before considering Call Money (1,64,500 + 2,00,000) | 3,64,500 |
| b. | Total Payments before final payment to Equity Shares (5,600 + 6,000 + 1,24,000 + 2,44,000) | 3,79,600 |
| c. | Deficit from above from Calls made on Equity Shares (a-b) | (15,100) |
| d. | Notional Call on 10,000 Partly Paid Shares at ` 2.50 each | 25,000 |
| e. | Surplus Cash Balance after Notional Call (comparing c and d) | 9,900 |
| f. | Number of Shares deemed fully paid (20,000 + 10,000) | 30,000 |
| g. | Hence, Refund on Fully Paid Shares ` 9,900 / 30,000 Shares (e ÷ f) | 33 paise |
| h. | Therefore, Required Call on Partly Paid Shares (2.50 – 0.33) | ` 2.17 |

# Section C

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

**(i) State the advantages of Social audit.**

**Answer:**

Advantages of Social audit

- Encourages community participation among different business entities.
- Ensures continuous efforts towards environmental protection and use of environment friendly production processes.
- Builds customer satisfaction and trust through ethical business practices.
- Promotes collective decision making and sharing responsibilities.
- Develops human resources by working towards improvement of workers' and the underprivileged persons' working/ living conditions.

**(ii) Explain the difference between a checklist and an Internal Control questionnaire.**

**Answer:**

Difference between a checklist and an Internal Control questionnaire

| S. No | Basis | Check List | Internal Control Questionnaire |
|---|---|---|---|

| | | | |
|---|---|---|---|
| a. | Point of Time | It is issued at the commencement of audit and reported back after completion of audit. | It can be issued at any point of time and reported back immediately. |
| b. | Issued To | It is issued to the audit staff to be followed by them during audit and reported back at completion. | It is issued to various people at different levels in the organization. |
| c. | Contents | It contains instructions to be followed by audit assistants. | It contains questions to be answered by the employees of the organization. |
| d. | Objective | It works as a guideline for audit staff so that no area remains unchecked | This is used to collect the information to know about the internal control system and evaluate the weaknesses therein. |

**(iii) Explain the difference between Test Check and Statistical Sampling.**

**Answer:**

Difference between Test Checking and Statistical Sampling

| S.No. | Basis | Test Checking | Statistical Sampling |
|---|---|---|---|
| a. | Selection | Selective transactions are verified. | Drawing a sample from a large number of transactions. |
| b. | Technique | No specific technique is used. | Statistical technique used is: selection on random basis. |
| c. | Subjective | It is subjective and depends upon the choice of the auditor. | It depends upon the statistical technique applied. |
| d. | Risk& Method | It involves more risk as there are no specific methods for test check. | It carries lesser risk and various statistical methods can be used at different times. |

**(iv) What types of analysis are covered by analytical procedures?**

**Answer:**

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

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

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

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

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

**(i) What are the matters should be considered by the auditor of the company while doing audit of Charitable Institutions? [8]**

**Answer:**

When conducting the audit of a charitable institution, the auditor should consider the following matters:

- The auditor should study the constitution of the charitable institution, f[redacted] is set up under the Societies Registration Act or as per section 25 of the [redacted] a trust.
- Obtain a list of members of the governing body. This will help the auditor in identifying whether any of the members of the governing body has any interest in the charitable institution.
- The auditor should obtain a copy of the budget sanctioned or the financial statement. This would enable him to acquaint himself with the different heads of income and expenditures of incomes and expenditures of the institution.
- Examination of the system of internal check, especially as regards the accounting of the amounts collected.
- Check that the amounts received towards income have been duly collected, received and deposited into the bank regularly and promptly.
- These institutions receive subscriptions and donations which form the major part of their collections. Therefore the auditor should check the following:
- The amount or the rate of the annual subscription.
- Any instructions given by the donors as to the specific utilization of donation.
- Adequacy of internal controls existing as regards unused receipt books, counter foils, etc.
- Where subscriptions are received in advance these should be properly dealt with in the accounts.
- Verify the amounts of legacies received by reference to correspondence with any figures and other available informations.
- Where the institution has made any investments or given loans, the amount of dividend and interest should be properly vouched with reference to the counterfoils or dividend warrants

received. It should be ensured that such loans or grants are given under proper authorizations.

- If some property is given or taken on rent, then the auditor should check the tenancy agreement, the rent slips and the authorized person for the collection or payment, as the case may be, of the rent.
- Most of the organisations organize special functions such as concert etc. The auditor should be careful in such cases. All the gross receipts and outgoings are to be properly vouched by him. It should be ensured that proper internal check was maintained as regards the receipts and outgoings. For example, the person responsible for collection and disbursements should be separate persons.
- The expenditure of charitable institution is also one of the major areas of concern. Thus the auditor should verify that the expenditure is made only for the charitable purpose. If the expenditure is not for the charitable purpose, then the auditor should examine the implications of applicable law and document for the same.
- The auditor should physically verify the cash in hand, inventories and fixed assets.

**(ii) What are the scope of Audit Committee of the company?**

**Answer:**

An Audit Committee consists of three to five members formed to serve as communication link among various departments. Audit Committee has a fourfold relationship and therefore has to interact with management, internal auditor, statutory auditor and the public.

The Scope of Audit Committee can be discussed as follows: -

- Review of annual financial statements before submission to the Board of Directors.
- Selection of the Statutory Auditor
- Act as lies on between the Statutory Auditor and Board of Directors
- Administrative control of the internal control functions through the feedback between the Internal Auditor and the Audit Committee.
- Over seeing internal central operation.
- Over seeing internal audit operations and feedback between internal audit committee and developing the internal auditing authority through broad based internal audit programming.
- Review and approval of financial information for publication
- Review proposed changes in accounting system and procedures.
- Help resolve differences between management, internal and statutory auditor.
- Report on the audit committee acting in the Annual Reports of Board of Directors.
- Ensure reliability of organisation's financial statements and operational activities. To be effective and purposeful, the audit committee should maintain the following:-

- Audit Committee should have the independence of management, Statutory Auditor and Internal Auditor. The Board of Directors allows full freedom to the audit committee to investigate into any areas of operation.
- The relation between the audit committee and management should be cordial and congenial towards optimum efficiency and healthy growth of the organization.
- There should be a regular line of communication through occasional meetings with the management.
- There should be good communication relationship interwoven among management, internal auditor and statutory auditor.

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

(a) **How to verify the following –** **[3x4 = 12]**
**(i) Verification of Contingent Liability**
**(ii) Verification of Plant & Machinery**
**(iii) Freehold Land & Building**

**Answer:**
(i) Verification of Contingent Liability

Auditor should carefully verify contingent liabilities as it may become actual liability on happening or not happening certain events and while verifying keep in mind following points.

- Obtain certificate about the contingent liabilities disclosed in the Balance Sheet, from a responsible officer.
- Carefully examine whether such liabilities are in existence or not.
- Check relevant documents to confirm the existence of contingent liability.
- Verify the certified list given by responsible officer to ascertain whether there exists any contingent liability which may turn to be an actual liability.
- Verify whether proper provision is made or not for the contingent liability turned out to be an actual liability.
- Verify bill discounting register, investment register, minute book and other relevant records to establish the amount of contingent liability.
- See whether contingent liability is properly disclosed in the Balance Sheet.

**(ii) Verification of Plant & Machinery**

As in case of industrial concern out of total assets 20% to 50% cost is that of Plant & Machinery and hence the auditor is required to take much more precaution while verifying the Plant and Machinery and for this he should give attention to following points-

- He should get the detailed list of all Plant and Machineries and asset wise accumulated depreciation.
- He should trace the opening balance in the Plant & Machinery register with the help of last year's audited balance sheet.

- He should verify quotations, invoices, cost etc., in connection with Purchase of Plant & Machinery. If there are sales of Plant & Machinery in audit period he should verify the invoice to that effect. He should check the Board Resolution authorizing Purchases of Plant & Machinery.
- If any machinery is disposed off and sold as scrap during the audit period, he should check the authorization and values report in that connection.
- He should check the rates and calculation of depreciation and ensure these are according to the provision of Section 205 of the Companies Act, 1956.
- He should check whether related expenses incurred on purchases of machinery are duly capitalized.
- He should check whether proper accounting of profit earned or loss suffered on Sale of Machinery, during the audit period, is done.
- If any machine is manufactured by the client itself, auditor should verify that capitalization of material, labor and other expenses is properly done.
- He should obtain from the Company management certificate about the verification of all items as required under CARO.
- He should scan the Plant register and physically inspect some of the major plants by visiting to the works.
- He should, finally, ensure appropriate disclosure of all information on the balance sheet as required by the Companies Act.
- He should obtain a certificate from the local auditor to that effect, if Plant and Machinery is kept abroad at a distant place.

**(iii) Freehold Land & Building**

- He should see that Freehold Land and Buildings are shown separately and not mixed with lease hold or other assets.
- He should see that separate accounts for land and for buildings are mentioned because on land usually no depreciation is provided.
- He should see that the balance shown on Balance Sheet is directly traceable from respective ledger account.
- He should examine the title deeds of the property and see that the asset is in the name of the client and in the free and fair possession of the client.
- He should examine that the title deed is genuine.
- The Purchases during the year be examined with the related correspondence, broker's note, auctioneer's note.
- In case of construction of the building auditor should examine the various certificates such as Builder's certificate, Contractor's certificates, Architect's certificate, Local authority certificate where needed.
- He should verify the sale, if a part of property has been sold during the period under audit.
- He should obtain a certificate from mortgagee if the property has been mortgaged and the deeds are with the mortgagee to verify the property.
- Land is not subject to depreciation but see that proper depreciation is provided on building as per the provision of Sec 205 of the Companies Act, 1956.

- See that the fluctuation in the value is not to be considered on Balance Sheet but if it has been considered then see that this is properly disclosed on Balance Sheet.
- Auditor should physically verify the existence of asset.

(b) **(i) Explain the features and Scope of an Internal Audit.** **[6]**

**Answer:**

Features of Internal Audit

- It is an independent appraisal activity within the organization.
- It can be conducted by the staff of the entity or by an independent professional appointed for that purpose.
- It is conducted for review of accounting, financial and other operations and controls established within an organization.
- It is conducted as a service to the organization and is not a part of the organization.
- It intends to furnish the analysis, appraisals, suggestions and information concerning the activities reviewed to the management.
- Internal auditing functions as a continuous effort for promoting effective control at cost reasonable cost.

Scope

The Institute of Internal Auditors defines scope of internal auditing as 'examination and evaluation of the adequacy and effectiveness of organisation's system of internal control and the quality of actual performance'. Therefore, internal auditing is concerned with an evaluation of both internal control as well as the quality of actual performance. According to the Institute, the scope of internal audit involves the following:

- Review the reliability and integrity of financial and operating information and the means to locate, identify, measure, classify and report such information.
- Appraise the economy and efficiency with which resources are employed.
- Review the systems established to ensure compliance with those policies, plans, procedures, laws and regulations which could have a significant effect and impact on operations and report, and should determine whether the organization is in compliance.
- Review the means of safeguarding assets and as appropriate verify the existence of such assets.
- Review operations or programs to ascertain whether results are consistent with established objectives and goals and whether the operations or programs are being carried out as planned.
- Internal auditing, therefore, is a function distinct from authorization and recording. It is concerned not only with examination of the transaction as recorded in the books of accounts but also with appraisal or procedure with a view to effecting change for better efficiency, where possible.

**(ii) What are the difference between Internal Audit and External Audit?** **[6]**

**Answer:**

Distinction between Internal Audit and External Audit

On accounting matters, the internal and external auditors operate mainly in the same field and they have a common interest in ascertaining that there is an effective system of internal control for presentation and detection of errors and frauds and to ensure that it is operating satisfactorily and that an adequate accounting system exists to provide the information necessary for preparing true and fair financial statements. There are some fundamental differences between the work of an internal auditor and that of an external auditor regarding the following:

- Appointment: The internal auditor is appointed by the management, generally the Directors and is responsible to them.
- The external or the statutory auditor is appointed according to the concerned statute. Generally, in case of company form of organization, the auditors are appointed by the shareholders in the annual general meeting.
- Scope: The extent of the work undertaken by the internal auditor is determined the management.
- The external auditor undertakes the area of the work which arises from the responsibilities placed on him by the governing statute.
- Approach: The internal auditor's approach is with a view to ensure that the accounting system is efficient, so that the accounting information presented to management throughout the period is accurate and discloses material facts.
- The external auditor's approach is governed by his responsibility to satisfy himself that the accounts to be presented to the shareholders show a true and fair view of the profit or loss for the financial period and of the company's state of affairs at the end of that period.
- Responsibility: The internal auditor's responsibility is to the management. It follows that the internal auditors, being a servant of the company, does not have independence of status.
- The external auditors, however, is responsible directly to the shareholders. Unlike the internal auditors, he is a representative of the shareholders and has independence of status.
- Objective: The main objective of internal audit is to ensure that the laid down policies, procedures and other internal control functions are functioning as designed.
- Whereas the objective of the external auditor is to express opinion and view to on financial statements whether those statements are showing true and fair view of the organisation.
- Independence: External auditor is more independent than internal auditor in the field of reporting.

Except these important differences, the work of both the internal auditor and the external auditor, on matters of accounting, is carried out largely by similar means, such as:

- Examination of the system of internal check, for both soundness and principle and effectiveness in operation.
- Examination and checking of accounting records and statements.
- Verification of assets and liabilities.
- Observations, inquiry, making of statistical comparisons and such other measures as may be judged necessary.

The wide experience of the external auditor may be of assistance to the internal auditor: while on the other side the latter's intimate acquaintance with business concern may be of help to the external auditors. Co-operation in planning of the respective auditors may save unnecessary works, although the external auditors must always satisfy himself as to the work carried out by the internal auditors.

**(c) (i) On the audit of Dreamlight Ltd. the audit partner of the engagement set the preliminary level of audit materiality at `12,00,000. After, the partner reviewed the audit of senior's assessment of inherent risk, he decided that the materiality level should be increased to `18,00,000.**

**Required:**

**A. What is the relationship between materiality and audit risk?**

**B. How will this new level of materiality affect the nature and extent of auditing procedures? [8]**

**Answer:**

**A.** The relationship between materiality and audit risk:

The concept of materiality is applied by the auditor both in planning and [redacted] and in evaluating the effect of identified misstatements on the audit [redacted] misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

In planning the audit, the auditor makes judgments about the size of misstatements that will be considered material. These judgments provide a basis for:

- Determining the nature, timing and extent of risk assessment procedures;
- Identifying and assessing the risks of material misstatement; and
- Determining the nature, timing and extent of further audit procedures.

In conducting an audit of financial statements, the overall objectives of the auditor are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and to report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings. The auditor obtains reasonable assurance by obtaining sufficient appropriate audit evidence to reduce audit risk to an acceptably low level. Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk. Materiality and audit risk are considered throughout the audit, in particular, when:

- Identifying and assessing the risks of material misstatement;
- Determining the nature, timing and extent of further audit procedures; and
- Evaluating the effect of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

**B.** The auditor shall revise materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) in the event of becoming aware of information during the audit that would have

caused the auditor to have determined a different amount (or amounts) initially (Initially `12,00,000 and revised at `18,00,000).

If the auditor concludes that a lower materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) than that initially determined is appropriate, the auditor shall determine whether it is necessary to revise performance materiality, and whether the nature, timing and extent of the further audit procedures remain appropriate.

Materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) may need to be revised as a result of a change in circumstances that occurred during the audit (for example, a decision to dispose of a major part of the entity's business), new information, or a change in the auditor's understanding of the entity and its operations as a result of performing further audit procedures. For example, if during the audit it appears as though actual financial results are likely to be substantially different from the anticipated period end financial results that were used initially to determine materiality for the financial statements as a whole, the auditor revises that materiality.

**(ii) Explain the difference between Qualified Report and Adverse Report. [4]**

**Answer:**

Distinguish Between Qualified Report and Adverse Report

| | Qualified Report | Adverse Report |
|---|---|---|
| i. | A Qualified Audit Report is one an Auditor gives an opinion subject to certain reservations. | An Adverse Report is given when the concludes that based on his examination, he does not agree with the affirmations made in the Financial Statements / Financial Report. |
| ii. | The Auditor's reservation is generally Stated as: "Subject to the above, we report that the Balance Sheet shows a true and fair view." | The Auditor states that the Financial Statements do not present a true and fair view of the state of affairs and working results of the organisation. |
| iii. | The accounts present a true and fair view subject to certain reservations. | The accounts do not present a true and fair view on the whole. |
| iv. | A Qualification is made in the Audit Report when the Auditor has reservation on specific item(s) of material nature. | An Adverse Report is given when the Auditor has his reservations on the true and fair view presented by the Financial Statements. |

# Paper 12 - Company Accounts & Audit

**Full Marks: 100**

# Section A

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

**(i) Differentiate between Reporting Currency and Foreign Currency.**

**Answer:**

Difference between Reporting Currency and Foreign Currency

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

**(ii) Define Financial Assets and Financial Liability as per AS 20.**

**Answer:**

Financial Asset: A Financial Asset is any asset that is –
(a) Cash
(b) A contractual right to receive cash or another Financial Asset from another Enterprise,
(c) A contractual right to exchange Financial Instruments with another Enterprise, under conditions that are potentially favorable, or
(d) An Equity Share of another Enterprise.

Financial Liability: A Financial Liability is any liability that is a contractual obligation –
(a) To deliver cash or another Asset to another Enterprise, or
(b) To exchange Financial Instruments with another Enterprise, under conditions that are potentially unfavourable.

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

**(a) Explain the objective of Financial Statements.** **[8]**

**Answer:**

Objective of Financial Statements

The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions. This would guide in deciding statements, their contents and disclosures.

A set of general purpose financial statements focus on financial position, performance and cash flows of an entity which could be used by any user group to assess investment decision,

employment stability or growth, debt servicing, business continuity and ability to make societal contribution. General purpose financial statements are those intended to meet the needs of users who are not in a position to require an entity to prepare reports tailored to their particular information needs.

A complete set of financial statements as worked out in Para 10 of IAS 1 is the outcome of the Framework which in turn is linked to subserve the information need of various user-groups. It comprises of:

(i) a statement of financial position as at the end of the period;

(ii) a statement of comprehensive income for the period ;

(iii) a statement of changes in equity for the period;

(iv) a statement of cash flows for the period;

(v) notes, comprising a summary of significant accounting policies and other explanatory information; and

(vi) a statement of financial position as at the beginning of the earliest comparative period when an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements.

Notes, comprising a summary of significant accounting policies and other explanatory information are important components of financial statements as they explain various elements of financial statements. Disclosure of risks adds to the information content of the financial statements.

Earning per share information contained in the Income Statement is focused information to shareholders as regards entity's performance. Information regarding diluted earning improves the information communique working out the effect of possible equity dilution actions. Similarly, segment reporting is intended to provide disaggregated information based on operating and / or geographic segments, consolidated financial statements focus on providing aggregated financial information for the entity-group as a whole, related party disclosures are intended to highlight non-market oriented transactions, if any. Thus the origination and improvement in disclosure and presentation standards have the purpose of making a set of general purpose financial statements useful to the diverse user-groups.

**(b) (i) Compute Basic Earnings Per Share from the following information –**

| **Date** | **Particulars** | **No. of Shares** |
|---|---|---|
| **1st April 2011** | **Balance at the beginning of the year** | **1,500** |
| **1st August 2011** | **Issue of Shares for Cash** | **600** |
| **31st March 2012** | **Buy back of Shares** | **500** |

**Net Profit for year ended 31st March 2012 was `2,75,000.** **[4]**

**Answer:**

1. Computation of Weighted Average Number of Shares outstanding during the period

| Date | No. of Equity share | Period Outstanding | Time Weighting factor | Weighted Avg. No. of Shares |
|---|---|---|---|---|
| (1) | (2) | (3) | (4) | (5)= (2) x (4) |
| 1st April 2011 | (Opening) 1,500 | 12 months | 12/12 | 1,500 |
| 1st August 2011 | (Fresh Issue) 600 | 8 months | 8/12 | 400 |
| 31st March 2012 | (Buy Back) 500 | 0 Months | 0/12 | - |

| | |
|---|---|
| Weighted average Number of Equity Shares Outstanding during the period | 1,900 |

2. Basic EPS = $\dfrac{\text{Net Profit or Loss attributable to Equity Shareholders}}{\text{Weighted Average Number of Equity shares Outstanding}}$

$= \dfrac{\text{` } 2,75,000}{1,900 \text{ Shares}}$ = `144.74 per Share.

**(ii) Discuss the accounting treatment for Operating Leases in the Financial statements of Lessor. [4]**

**Answer:**

(a) Asset Recognition: The Lessor should present an Asset given under Operating Lease in its Balance Sheet under Fixed Assets.
(b) Income Recognition: Lease Income (excluding receipts for services provided, e.g. insurance and maintenance), should be recognised in the Statement of Profit and Loss on a Straight Line Basis over the Lease Term, even if it is not received on that basis, unless another systematic basis is more representative of the time pattern in which benefit derived from the use of the leased asset is diminished.
(c) Cost Recognition: Costs, including Depreciation, incurred in earning the Lease Income are recognised as an Expense.
(d) Initial Direct Costs: Initial Direct Costs incurred specifically to earn revenues are either - (a) deferred and allocated to income over the lease term in proportion [redacted] Rent Income, or (b) are recognised as an Expense in the Statement [redacted] period in which they are incurred.
(e) Depreciation: Depreciation of Leased Assets should be on a basis consistent with the normal depreciation policy of the Lessor for similar assets. The Depreciation charge should be calculated on the basis set out in AS - 6.
(f) Impairment Losses: The Lessor should apply AS - 28 to determine whether a Leased Asset has become impaired, and treat such impairment accordingly.
(g) Selling Profit: A Manufacturer or Dealer Lessor does not recognise any Selling Profit on entering into an Operating Lease, because it is not the equivalent of a sale.

**(c) Write short notes on recognition of Past Service Cost. [8]**

**Answer:**

1. Recognition as Expense:
   (a) In measuring its Defined Benefit Liability under Para 55, an Enterprise should recognise Past Service Cost as an expense, on a straight-line basis over the average period until the benefits become vested.
   (b) To the extent that the benefits are already vested immediately following the introduction of, or changes to, a Defined Benefit Plan, an enterprise should recognise Past Service Cost immediately.

   Example:

   An Enterprise operates a pension plan that provides a pension of 2% of final salary for each year of service. The benefits become vested after 5 years of service. On 1st January 20X4, the Enterprise improves the pension to 2.5% of final salary for each year of service starting from 1st January 20X0.

   Suppose, at the date of the improvement, the PV of the additional benefits for service from 1st Jan 20X0 to 1st January 20X4 is as follows -

| | |
|---|---|
| Employees with more than 5 years' service at 01.01.20X4 | `150 |
| Employees with less than 5 years' service at 01.01.20X4 | `120 |
| (Average period until vesting: 3 years) | |
| | `270 |

In this case, the Enterprise should recognise `150 immediately because those benefits are already vested. The Enterprise should recognise `120 on a straight-line basis over 3 years from 1st January 20X4.

2. Amendment of Amortisation Schedule: An Enterprise establishes the amortisation schedule for Past Service Cost when the benefits are introduced or changed. It would be impracticable to maintain the detailed records needed to identify and implement subsequent changes in that amortisation schedule. Also, the effect is likely to be material only where there is a curtailment or settlement. So, an Enterprise should amend the amortisation schedule for Past Service Cost, only if there is a curtailment or settlement.
3. Negative Past Service Cost: Where an Enterprise reduces benefits payable under an existing Defined Benefit Plan, the resulting reduction in the Defined Benefit Liability is recognised as (negative) Past Service Cost over the average period, until the reduced portion of the benefits becomes vested.
4. Net Change: Where an Enterprise reduces certain benefits payable under an existing Defined Benefit Plan and, at the same time, increases other benefits payable under the plan for the same employees, the Enterprise treats the change as a single net change.

# Section B

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

**(i) Explain the disclosure requirement of Deferred tax assets.**

**Answer:**

Deferred Tax Asset - Disclosure requirement

To be shown as a separate line item on the face of Balance Sheet.

**(ii) Explain the disclosure requirement of Intangible assets under development.**

**Answer:**

Intangible Assets under Development - Disclosure requirement

To be shown as a separate line item on the face of Balance Sheet.

Note - Intangible Assets under development should be disclosed under this head provided they can be recognized based on the criteria laid down in AS-26.

**(iii) What is meant by List B of Contributories?**

**Answer:**

a) Persons: Shareholders who had transferred Partly Paid Shares (otherwise than by operation of law or by death) within one year, prior to the date of winding up may be called upon to pay an

amount to pay off such Creditors as existed on the date of transfer of shares. These Transferors are called as B List Contributories.

b) Liability: Their liability is restricted to the amount not called up when the shares were transferred. They cannot be called upon to pay more than the entire face value of the share. For example, if Shares having Face Value of `100 were paid up `60, the B List Contributory can be called up to pay a maximum of `40 only.

c) Conditions: Liability of B List Contributories will crystallize only (a) when the existing assets available with the liquidator are not sufficient to cover the liabilities; (b) when the existing shareholders fail to pay the amount due on the shares to the Liquidator.

**(iv) What are the disclosure requirements of reportable segment under AS 17?**

**Answer:**

An enterprise should disclose the following for each reportable segment:

(a) segment revenue, classified into segment revenue from sales to external customers and segment revenue from transactions with other segments;

(b) segment result;

(c) total carrying amount of segment assets;

(d) total amount of segment liabilities;

(e) total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (tangible and intangible fixed assets);

(f) total amount of expense included in the segment result for depreciation and amortisation in respect of segment assets for the period; and

(g) total amount of significant non-cash expenses, other than depreciation and amortisation in respect of segment assets, that were included in segment expense and, therefore, deducted in measuring segment result.

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

**(a) On 1st April 2009, Gravity Ltd. issued 442, 10% Debentures of ` 1000 each at a discount of 10% redeemable at a premium of 5% after 4 years. It was decided to create a Sinking Fund for the purposes of accumulating sufficient funds to redeem the Debentures and to invest in some radily convertible securities yielding 10% interest p.a. Reference to the table shows that `1.00 p.a. at 10% compound interest amounts to `4.641 in 4 years. Investments are to be made in the Bonds of `1000 each available at par.**

**On 31st March 2013, the investments realised `3,40,000 and debentures were redeemed. The bank balance as on that date was `50,000.**

**Required: Prepare Debenture Redemption Fund Account and Debenture Redemption Fund Investments Account for 4 years. [16]**

**Answer:**

DRF = Debenture Redemption Fund, DRFI = Debenture Redemption Fund Investment

Dr. Discount on Issue of Debentures Account Cr.

| Date | Particulars | ` | Date | Particulars | ` |
|---|---|---|---|---|---|
| 31.03.10 | To Balance c/d | 1,00,000 | 31.03.10 | By P & L App. A/c | 1,00,000 |
| 31.03.11 | To Balance c/d | 2,10,000 | 01.04.10 | By Balance b/d | 1,00,000 |
| | | | 31.03.11 | By Interest on DRFI A/c | 10,000 |
| | | | | By P & L App. A/c | 1,00,000 |
| | | 2,10,000 | | | 2,10,000 |
| 31.03.12 | To Balance c/d | 3,31,000 | 01.04.11 | By Balance b/d | 2,10,000 |
| | | | | By Interest on DRFI A/c | 21,000 |
| | | | | By P & L App. A/c | 1,00,000 |
| | | 3,31,000 | | | 3,31,000 |
| 31.03.13 | To Loss on issue of Debentures (premium) | 22,100 | 01.04.12 | By Balance b/d | 3,31,000 |
| | To Debenture Redemption Reserve A/c | 4,52,000 | | By Interest on DRFI A/c | 33,100 |
| | | | | By P & L App. A/c | 91,000 |
| | | | | By Debenture [redacted] Investment A/c [redacted] | |
| | | 4,74,100 | | | 4,74,100 |

Dr. Debentures Redemption Fund Investment (DRFI) Account Cr.

| Date | Particulars | ` | Date | Particulars | ` |
|---|---|---|---|---|---|
| 31.03.10 | To Bank A/c | 1,00,000 | 31.03.10 | By Balance c/d | 1,00,000 |
| 01.04.10 | To Balance b/d | 1,00,000 | 31.03.11 | By Balance c/d | 2,10,000 |
| 31.03.11 | To Bank A/c | 1,10,000 | | | |
| | | 2,10,000 | | | 2,10,000 |
| 01.04.11 | To Balance b/d | 2,10,000 | 31.03.12 | By Balance c/d | 3,31,000 |
| 31.03.12 | To Bank A/c | 1,21,000 | | | |
| | | 3,31,000 | | | 3,31,000 |
| 01.04.12 | To Balance b/d | 3,31,000 | 31.03.13 | By Bank A/c (Sales) | 3,50,000 |
| 31.03.13 | To Debenture Redemption Fund A/c (Profit) | 9,000 | | | |
| | | 3,50,000 | | | 3,50,000 |

**Working Note:**

(i) Calculation of the amount of profit set aside

| | | ` |
|---|---|---|
| a. | Face Value of Debentures | 4,42,000 |

| | | |
|---|---|---|
| b. | Premium Payable on Redemption | 22,100 |
| c. | Depreciable Cost (A + B) | 4,64,100 |
| d. | Value of annuity per `1 | 4,641 |
| e. | Annual amount to be charged (C/D) | 1,00,000 |

(ii) Calculation of the amount of investments and interest

| Year | Opening Balance | Interest | Saving | Investments | Closing Balance |
|---|---|---|---|---|---|
| a | b | c = b×10/100 | d | e = c + d | f = b + e |
| 2009-10 | — | — | 1,00,000 | 1,00,000 | 1,00,000 |
| 2010-11 | 1,00,000 | 10,000 | 1,00,000 | 1,10,000 | 2,10,000 |
| 2011-12 | 2,10,000 | 21,000 | 1,00,000 | 1,21,000 | 3,31,000 |
| 2012-13 | 3,31,000 | 33,100 | 1,00,000 | — | — |

**(b) Given below is the Extract Trial Balance of Ramesh Ltd. and Dinesh Ltd. as on 31.3.2013. Dinesh Ltd. was merged with Ramesh Ltd. with effect from 01.04.2013.**

**Trial Balance (Extract) as on 31.3.2013 (`)**

| **Particulars** | **Ramesh Ltd.** | | **Dinesh Ltd.** | |
|---|---|---|---|---|
| | **Dr.** | **Cr.** | **Dr.** | **Cr.** |
| **Equity Shares of ` 10 each** | | **14,00,000** | | **5,00,000** |
| **General Reserve** | | **7,00,000** | | **2,40,000** |
| **Profit and Loss A/c** | | **4,20,000** | | **1,30,000** |
| **Export Profit Reserve** | | **1,40,000** | | **80,000** |
| **12% Debentures** | | **2,00,000** | | **2,00,000** |
| **Sundry Creditors** | | **80,000** | | **90,000** |
| **Provision for Taxation** | | **2,00,000** | | **1,20,000** |
| **Proposed Dividend** | | **2,80,000** | | **1,00,000** |
| **Sundry Fixed Assets (Tangible)** | **19,00,000** | | **8,00,000** | |
| **Investments (Non-trade)** | **4,00,000** | | **1,00,000** | |
| **Stock (opening)** | **2,40,000** | | **1,00,000** | |
| **Debtors** | **1,50,000** | | **1,60,000** | |
| **Advance Tax** | **1,60,000** | | **40,000** | |
| **Cash and Bank balances** | **5,50,000** | | **2,60,000** | |
| **Preliminary Expenses** | **20,000** | | | |
| **Total** | **34,20,000** | **34,20,000** | **14,60,000** | **14,60,000** |

**Closing Stock of Ramesh and Dinesh is also `2,40,000 & `1,00,000 respectively. Ramesh Ltd. would issue 12% Debentures to discharge the claims of the debenture holders of Dinesh Ltd. at par. Non-trade investments of Ramesh Ltd. fetched @ 25% while those of Dinesh Ltd. fetched @ 18%.**

**Profit (pre-tax) by Ramesh Ltd and Dinesh Ltd. during 2010-11, 2011-12 and 2012-13 and were as follows:**

| **Year** | **Ramesh Ltd.** | **Dinesh Ltd.** |
|---|---|---|
| | ` | ` |
| **2010-11** | **10,00,000** | **3,00,000** |
| **2011-12** | **13,00,000** | **4,20,000** |
| **2012-13** | **11,50,000** | **3,60,000** |

**Goodwill may be calculated on the basis of capitalisation method taking 20% as the pre-tax normal rate of return. Purchase consideration is discharged by Ram Ltd. on the basis of intrinsic value per share. Both companies decided to cancel the proposed dividend.**

**Required: Balance Sheet of Ramesh Ltd. after merger. [16]**

**Answer:**

WN # 1: Purchase Consideration:

| | | |
|---|---|---|
| (i) | Shares outstanding in Dinesh Ltd. | 50,000 |
| (ii) | Intrinsic Value per Share of Dinesh Ltd. [WN # 2] | ` 36.20 |
| (iii) | Value of Shares (a × b) | ` 18,10,000 |
| (iv) | Intrinsic value per share of Ramesh Ltd. [WN # 2] | ` 40.40 |

(v) No. of shares to be issued by Ramesh Ltd.

` 18,10,000/ ` 40.40 = 44,801.99

| Shares | Cash for fractions |
|---|---|
| 44,801 | 0.99 × 40.40 = 40 |

(iv) Purchase consideration

(a) 44,801 shares @ 40.40

| | | |
|---|---|---|
| Capital [`10 / Share] | 4,48,010 | |
| Premium [`30.40 / Share] | 13,61,950 | = 18,09,960 |
| (b) Cash for fractional shares | | = 40 |
| (c) Total purchase consideration payable | | = 18,10,000 |

WH # 2: Intrinsic Value per share:

(`)

| | | | Ramesh Ltd. | | Dinesh Ltd. | |
|---|---|---|---|---|---|---|
| (i) | | Assets | | | | |
| | (a) | Goodwill | 27,30,000 | | 7,60,000 | |
| | (b) | Sundry Fixed assets | 19,00,000 | | 8,00,000 | |
| | (c) | Investments | 4,00,000 | | 1,00,000 | |
| | (d) | Stock | 2,40,000 | | 1,00,000 | |
| | (e) | Debtors | 1,50,000 | | 1,60,000 | |
| | (f) | Advance Tax | 1,60,000 | | 40,000 | |
| | (g) | Cash and Bank Balance | 5,50,000 | 61,30,000 | 2,60,000 | 22,20,000 |
| (ii) | | Liabilities | | | | |
| | (a) | 12% Debentures | 2,00,000 | | 2,00,000 | |

| | | | | | |
|---|---|---|---|---|---|
| | (b) Sundry creditors | 80,000 | | 90,000 | |
| | (c) Provision for tax | 2,00,000 | (4,80,000) | 1,20,000 | (4,10,000) |
| (iii) | Net Assets (i-ii) | | 56,50,000 | | 18,10,000 |
| (iv) | No. of Outstanding Shares | | 1,40,000 | | 50,000 |
| (v) | Intrinsic Value per share (iii)/(iv) | | 40.40 | | 36.20 |

W # 3: Valuation of Goodwill

A. Capital Employed

| | | | Ramesh Ltd. | | Dinesh Ltd. |
|---|---|---|---|---|---|
| (i) | Assets: | | | | |
| | (a) Sundry Fixed assets | 19,00,000 | | 8,00,000 | |
| | (b) Investment (Non-trade) | - | | - | |
| | (c) Stock | 2,40,000 | | 1,00,000 | |
| | (d) Debtors | 1,50,000 | | 1,60,000 | |
| | (e) Advance tax | 1,60,000 | | 40,000 | |
| | (f) Cash and Bank balance | 5,50,000 | 30,00,000 | 2,60,000 | 13,60,000 |
| (ii) | Liabilities: | | | | |
| | (a) 12% Debentures | 2,00,000 | | [redacted] | |
| | (b) Sundry creditors | 80,000 | | 90,000 | |
| | (c) Provision for tax | 2,00,000 | 4,80,000 | 1,20,000 | 4,10,000 |
| (iii) | Capital Employed: (i) - (ii) | | 25,20,000 | | 9,50,000 |

B. Average Pre-tax Profit:

| Particulars | | Ramesh Ltd. | Dinesh Ltd. |
|---|---|---|---|
| (i) | 2010-11 | 10,00,000 | 3,00,000 |
| (ii) | 2011-12 | 13,00,000 | 4,20,000 |
| (iii) | 2012-13 | 11,50,000 | 3,60,000 |
| (iv) | Total (a+b+c) | 34,50,000 | 10,80,000 |
| (v) | Simple Average [(iv)/3] | 11,50,000 | 3,60,000 |
| (vi) | Less: Non-trading income | (1,00,000) | (18,000) |
| (vii) | Average pre-tax profit | 10,50,000 | 3,42,000 |

C. Computation of Goodwill:

| Particulars | | Ramesh Ltd. | Dinesh Ltd. |
|---|---|---|---|
| | | ` | ` |
| a. | Capitalised value of average profits $\frac{10,50,000}{0.20};\frac{3,42,000}{0.20}$ | 52,50,000 | 17,10,000 |
| b. | Capital Employed | 25,20,000 | 9,50,000 |
| c. | Goodwill (a-b) | 27,30,000 | 7,60,000 |

Journal Entries - Books of Ramesh Ltd.

- Nature of Amalgamation – PURCHASE
- Method of Accounting – PURCHASE METHOD

| Particulars | | Debit | Credit |
|---|---|---|---|
| a. For Business Purchase : | | | |
| Business Purchase A/c | Dr. | 18,10,000 | |
| To Liquidator of Dinesh Ltd. A/c | | | 18,10,000 |
| b. For Assets and Liabilities taken over | | | |
| Goodwill A/c | Dr. | 7,60,000 | |
| Fixed Assets A/c | Dr. | 8,00,000 | |
| Investments A/c | Dr. | 1,00,000 | |
| Stock A/c | Dr. | 1,00,000 | |
| Debtors A/c | Dr. | 1,60,000 | |
| Advance tax A/c | Dr. | 40,000 | |
| Cash and Bank A/c | Dr. | 2,60,000 | |
| To 12% Debenture holders A/c | | | 2,00,000 |
| To Creditors A/c | | | 90,000 |
| To Provision for Taxation A/c | | | [redacted] |
| To Business Purchase A/c | | | [redacted] |
| c. For Discharge of Purchase Consideration: | | | |
| Liquidator of Dinesh Ltd. | Dr. | 18,10,000 | |
| To Equity Share capital A/c | | | 4,48,010 |
| To Securities premium A/c | | | 13,61,950 |
| To Cash A/c | | | 40 |
| d. Contra Entry | | | |
| Amalgamation Adjustment A/c | Dr. | 80,000 | |
| To Export Profit Reserve A/c | | | 80,000 |

Name of the Company: Ramesh Ltd.

Balance Sheet as at 31.03.2013

| Ref No. | Particulars | Note No. | As at 31st March, 2013 ` | As at 31st March, 2012 ` |
|---|---|---|---|---|
| I. | Equity and Liabilities | | | |
| 1 | Shareholders' funds | | | |
| | (a) Share capital | 1 | 18,48,010 | |
| | (b) Reserves and surplus | 2 | 29,81,950 | |
| | (c) Money received against share warrants | | | |
| 2 | Share application money pending allotment | | | |
| 3 | Non-current liabilities | | | |

| | | | |
|---|---|---|---|
| | (a) Long-term borrowings | 3 | 4,00,000 |
| | (b)Deferred tax liabilities (Net) | | |
| | (c) Other Long term liabilities | | |
| | (d) Long-term provisions | | |
| 4 | Current Liabilities | | |
| | (a) Short-term borrowings | | |
| | (b) Trade payables | 4 | 1,70,000 |
| | (c) Other current liabilities | | |
| | (d) Short-term provisions | 5 | 3,20,000 |
| | Total (1+2+3+4) | | 57,19,960 |
| II. | Assets | | |
| 1 | Non-current assets | | |
| | (a) Fixed assets | | |
| | (i) Tangible assets | 6 | 27,00,000 |
| | (ii) Intangible assets | 7 | 7,60,000 |
| | (iii) Capital work-in-progress | | |
| | (iv) Intangible assets under development | | |
| | (b) Non-current investments | 8 | 5,00,000 |
| | (c) Deferred tax assets (Net) | | |
| | (d) Long-term loans and advances | 9 | 2,00,000 |
| | (e) Other non-current assets | 10 | 80,000 |
| 2 | Current assets | | |
| | (a) Current investments | | |
| | (b) Inventories | 11 | 3,40,000 |
| | (c) Trade receivables | 12 | 3,10,000 |
| | (d) Cash and cash equivalents | 13 | 8,09,960 |
| | (e) Short-term loans and advances | | |
| | (f) Other current assets | 14 | 20,000 |
| | Total (1+2) | | 57,19,960 |

Note to the Accounts:-

`

| Note 1. Share Capital | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Authorised, Issued, Subscribed and Paid up Share Capital 1,84,801 Equity Shares of `10 each (of which 44,801 shares were issued for consideration other than cash) | 18,48,010 | |
| Total | 18,48,010 | |

| Note 2. Reserves and Surplus | | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|---|
| Securities Premium | | 13,61,950 | |
| General Reserve | | 7,0[illegible] | |
| Profit and Loss A/c | `4,20,000 | | |
| Add: Proposed Dividend Cancelled | `2,80,000 | 7,00,000 | |
| Export Profit reserve (1,40,000+80,000) | | 2,20,000 | |
| Total | | 29,81,950 | |

| Note 3. Long-term borrowings | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| 12% Debentures of `100 each (2,00,000+2,00,000) | 4,00,000 | |
| Total | 4,00,000 | |

| Note 4. Trade Payables | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Sundry Creditors (80,000 + 90,000) | 1,70,000 | |
| Total | 1,70,000 | |

| Note 5. Short term Provisions | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Provision for Tax (2,00,000 + 1,20,000) | 3,20,000 | |
| Total | 3,20,000 | |

| Note 6. Tangible Assets | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Sundry Fixed assets (19,00,000 + 8,00,000) | 27,00,000 | |
| Total | 27,00,000 | |

| Note 7. Intangible assets | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Goodwill | 7,60,000 | |
| Total | 7,60,000 | |

| Note 8. Noncurrent Investments | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Investment (4,00,000 + 1,00,000) | 5,00,000 | |
| Total | 5,00,000 | |

| Note 9. Long-term Loans and advances | As at 31st March, [redacted] | As at 31st [redacted] |
|---|---|---|
| Advance Tax (1,60,000 + 40,000) | 2,00,000 | |
| Total | 2,00,000 | |

| Note 10.Other Non-current assets | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Amalgamation Adjustment A/c | 80,000 | |
| Total | 80,000 | |

| Note 11. Inventories | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Stock (2,40,000 + 1,00,000) | 3,40,000 | |
| Total | 3,40,000 | |

| Note 12. Trade receivables | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Debtors (1,50,000 +1,60,000) | 3,10,000 | |
| Total | 3,10,000 | |

| Note 13. Cash and Cash Equivalents | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Cash and Bank balance (5,50,000 + 2,60,000 - 40) | 8,09,960 | |
| Total | 8,09,960 | |

| Note 14. Other Current Assets | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Preliminary Expenses | 20,000 | |
| Total | 20,000 | |

(c) **The following is the Extract Trial Balance of "Tarun Ltd". as on 30.09.2012: (Amount in `)**

| **Particulars** | | **Dr.** | **Cr.** |
|---|---|---|---|
| **11% Preference Shares of `10 each** | | | **2,00,000** |
| **20,000 Equity Shares of `10 each, fully paid** | | | **2,00,000** |
| **10,000 Equity Shares of ` 10 each, ` 7.50 paid** | | | **75,000** |
| **13% Debentures** | | | **3,00,000** |
| **Mortgage Loan** | | | **1,60,000** |
| **Bank Overdraft** | | | [redacted] |
| **Creditors for Trade** | | | [redacted] |
| **Arrears of Income tax (Assessments concluded in July 2004)** | | | |
| **Assessment Year 2010-2011 -** | **42,000** | | |
| **Assessment Year 2011-2012 -** | **10,000** | | **52,000** |
| **Land and Building** | | **2,40,000** | |
| **Sundry Current Assets** | | **7,90,000** | |
| **Profit & Loss Account** | | **77,000** | |
| **Debenture Issue expenses not written off** | | **4,000** | |
| **Total** | | **11,11,000** | **11,11,000** |

**Other Information**

- **Mortgage Loan was secured against Land and Buildings. Debentures were secured by a Floating Charge on all the other assets.**
- **The Company was unable to meet the payments and therefore the Debenture holders appointed a Receiver and this was followed by a resolution for Members Voluntary Winding Up.**
- **The Receiver for the Debenture holders brought the Land and Buildings to auction and realized `3,00,000. He also took charge of Sundry Assets of the value of `4,80,000 and realized `4,00,000.**
- **The Liquidator realized `2,00,000 on the sale of the balance of Sundry Current Assets.**
- **The Bank Overdraft was secured by a personal guarantee of two of the Directors of the Company and on the Bank raising a demand, the Directors paid off the dues from their personal resources.**
- **Costs incurred by the Receiver were ` 4,000 and by the Liquidator ` 5,600.**

- **The Receiver was not entitled to any remuneration but the Liquidator was to receive 3% Fee on the value of assets realized by him.**
- **Preference Shareholders had not been paid dividend for the period after 30.9.2010 and interest for the last half-year was due to Debenture holders.**

**From the above information, prepare the Liquidator's Receipts and Payments Account. [16]**

**Answer:**

Determination of Surplus received by Liquidator from Receiver

| Receipts | ` | Payments | ` |
|---|---|---|---|
| Land and Buildings | 3,00,000 | Debenture Interest (3,00,000 x 13% x 6/12) | 19,500 |
| Sundry Current Assets | 4,00,000 | Income Tax Arrears (42,000 + 10,000) | 52,000 |
| | | Expenses of Receiver Given | 4,000 |
| | | Mortgage Loan Given | 1,60,000 |
| | | Debenture holders Principal Amount | 3,00,000 |
| | | Balance Surplus handed over to [redacted] (b/f) | |
| Total | 7,00,000 | | 7,00,000 |

Liquidator's Receipts & Payments Account

| Receipts | ` | Payments | | ` |
|---|---|---|---|---|
| Surplus received from Receiver (WN 1) | 1,64,500 | Remuneration to Liquidator (2,00,000 x 3%) | | 6,000 |
| | | Cost of Liquidation | | 5,600 |
| Sundry Assets realized | 2,00,000 | Unsecured Creditors: | | |
| Calls on Contributories | 21,700 | - Trade Creditors | 64,000 | |
| - From 10,000 Partly Paid Shares at ` 2.17 per share (See WN 3 below) | | - Directors (for Bank Overdraft paid) | 60,000 | 1,24,000 |
| | | Preference Shareholders: | | |
| | | - Share Capital | 2,00,000 | |
| | | - Arrears of Dividend (2 yrs) | 44,000 | 2,44,000 |
| | | Equity Shareholders' Final Payment | | |
| | | - Return of money to holders of 20,000 Fully Paid Shares at ` 0.33 each | | 6,600 |
| Total | 3,86,200 | Total | | 3,86,200 |

Calls from Holders of Partly Paid Shares

| | Particulars | ` |
|---|---|---|
| a. | Total of Receipts before considering Call Money (1,64,500 + 2,00,000) | 3,64,500 |
| b. | Total Payments before final payment to Equity Shares (5,600 + 6,000 + 1,24,000 + 2,44,000) | 3,79,600 |
| c. | Deficit from above from Calls made on Equity Shares (a-b) | (15,100) |
| d. | Notional Call on 10,000 Partly Paid Shares at ` 2.50 each | 25,000 |
| e. | Surplus Cash Balance after Notional Call (comparing c and d) | 9,900 |
| f. | Number of Shares deemed fully paid (20,000 + 10,000) | 30,000 |
| g. | Hence, Refund on Fully Paid Shares ` 9,900 / 30,000 Shares (e ÷ f) | 33 paise |
| h. | Therefore, Required Call on Partly Paid Shares (2.50 – 0.33) | ` 2.17 |

# Section C

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

**(i) State the advantages of Social audit.**

**Answer:**

Advantages of Social audit

- Encourages community participation among different business entities.
- Ensures continuous efforts towards environmental protection and use of environment friendly production processes.
- Builds customer satisfaction and trust through ethical business practices.
- Promotes collective decision making and sharing responsibilities.
- Develops human resources by working towards improvement of workers' and the underprivileged persons' working/ living conditions.

**(ii) Explain the difference between a checklist and an Internal Control questionnaire.**

**Answer:**

Difference between a checklist and an Internal Control questionnaire

| S. No | Basis | Check List | Internal Control Questionnaire |
|---|---|---|---|

| | | | |
|---|---|---|---|
| a. | Point of Time | It is issued at the commencement of audit and reported back after completion of audit. | It can be issued at any point of time and reported back immediately. |
| b. | Issued To | It is issued to the audit staff to be followed by them during audit and reported back at completion. | It is issued to various people at different levels in the organization. |
| c. | Contents | It contains instructions to be followed by audit assistants. | It contains questions to be answered by the employees of the organization. |
| d. | Objective | It works as a guideline for audit staff so that no area remains unchecked | This is used to collect the information to know about the internal control system and evaluate the weaknesses therein. |

**(iii) Explain the difference between Test Check and Statistical Sampling.**

**Answer:**

Difference between Test Checking and Statistical Sampling

| S.No. | Basis | Test Checking | Statistical Sampling |
|---|---|---|---|
| a. | Selection | Selective transactions are verified. | Drawing a sample from a large number of transactions. |
| b. | Technique | No specific technique is used. | Statistical technique used is: selection on random basis. |
| c. | Subjective | It is subjective and depends upon the choice of the auditor. | It depends upon the statistical technique applied. |
| d. | Risk& Method | It involves more risk as there are no specific methods for test check. | It carries lesser risk and various statistical methods can be used at different times. |

**(iv) What types of analysis are covered by analytical procedures?**

**Answer:**

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

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

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

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

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

**(i) What are the matters should be considered by the auditor of the company while doing audit of Charitable Institutions? [8]**

**Answer:**

When conducting the audit of a charitable institution, the auditor should consider the following matters:

- The auditor should study the constitution of the charitable institution, fo [illegible] is set up under the Societies Registration Act or as per section 25 of the Companies Act or as a trust.
- Obtain a list of members of the governing body. This will help the auditor in identifying whether any of the members of the governing body has any interest in the charitable institution.
- The auditor should obtain a copy of the budget sanctioned or the financial statement. This would enable him to acquaint himself with the different heads of income and expenditures of incomes and expenditures of the institution.
- Examination of the system of internal check, especially as regards the accounting of the amounts collected.
- Check that the amounts received towards income have been duly collected, received and deposited into the bank regularly and promptly.
- These institutions receive subscriptions and donations which form the major part of their collections. Therefore the auditor should check the following:
- The amount or the rate of the annual subscription.
- Any instructions given by the donors as to the specific utilization of donation.
- Adequacy of internal controls existing as regards unused receipt books, counter foils, etc.
- Where subscriptions are received in advance these should be properly dealt with in the accounts.
- Verify the amounts of legacies received by reference to correspondence with any figures and other available informations.
- Where the institution has made any investments or given loans, the amount of dividend and interest should be properly vouched with reference to the counterfoils or dividend warrants

received. It should be ensured that such loans or grants are given under proper authorizations.

- If some property is given or taken on rent, then the auditor should check the tenancy agreement, the rent slips and the authorized person for the collection or payment, as the case may be, of the rent.
- Most of the organisations organize special functions such as concert etc. The auditor should be careful in such cases. All the gross receipts and outgoings are to be properly vouched by him. It should be ensured that proper internal check was maintained as regards the receipts and outgoings. For example, the person responsible for collection and disbursements should be separate persons.
- The expenditure of charitable institution is also one of the major areas of concern. Thus the auditor should verify that the expenditure is made only for the charitable purpose. If the expenditure is not for the charitable purpose, then the auditor should examine the implications of applicable law and document for the same.
- The auditor should physically verify the cash in hand, inventories and fixed assets.

**(ii) What are the scope of Audit Committee of the company?**

**Answer:**

An Audit Committee consists of three to five members formed to serve as communication link among various departments. Audit Committee has a fourfold relationship and therefore has to interact with management, internal auditor, statutory auditor and the public.

The Scope of Audit Committee can be discussed as follows: -

- Review of annual financial statements before submission to the Board of Directors.
- Selection of the Statutory Auditor
- Act as lies on between the Statutory Auditor and Board of Directors
- Administrative control of the internal control functions through the feedback between the Internal Auditor and the Audit Committee.
- Over seeing internal central operation.
- Over seeing internal audit operations and feedback between internal audit committee and developing the internal auditing authority through broad based internal audit programming.
- Review and approval of financial information for publication
- Review proposed changes in accounting system and procedures.
- Help resolve differences between management, internal and statutory auditor.
- Report on the audit committee acting in the Annual Reports of Board of Directors.
- Ensure reliability of organisation's financial statements and operational activities. To be effective and purposeful, the audit committee should maintain the following:-

- Audit Committee should have the independence of management, Statutory Auditor and Internal Auditor. The Board of Directors allows full freedom to the audit committee to investigate into any areas of operation.
- The relation between the audit committee and management should be cordial and congenial towards optimum efficiency and healthy growth of the organization.
- There should be a regular line of communication through occasional meetings with the management.
- There should be good communication relationship interwoven among management, internal auditor and statutory auditor.

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

(a) **How to verify the following –** **[3x4 = 12]**
**(i) Verification of Contingent Liability**
**(ii) Verification of Plant & Machinery**
**(iii) Freehold Land & Building**

**Answer:**
(i) Verification of Contingent Liability

Auditor should carefully verify contingent liabilities as it may become actual liability on happening or not happening certain events and while verifying keep in mind following points.

- Obtain certificate about the contingent liabilities disclosed in the Balance Sheet, from a responsible officer.
- Carefully examine whether such liabilities are in existence or not.
- Check relevant documents to confirm the existence of contingent liability.
- Verify the certified list given by responsible officer to ascertain whether there exists any contingent liability which may turn to be an actual liability.
- Verify whether proper provision is made or not for the contingent liability turned out to be an actual liability.
- Verify bill discounting register, investment register, minute book and other relevant records to establish the amount of contingent liability.
- See whether contingent liability is properly disclosed in the Balance Sheet.

**(ii) Verification of Plant & Machinery**

As in case of industrial concern out of total assets 20% to 50% cost is that of Plant & Machinery and hence the auditor is required to take much more precaution while verifying the Plant and Machinery and for this he should give attention to following points-

- He should get the detailed list of all Plant and Machineries and asset wise accumulated depreciation.
- He should trace the opening balance in the Plant & Machinery register with the help of last year's audited balance sheet.

- He should verify quotations, invoices, cost etc., in connection with Purchase of Plant & Machinery. If there are sales of Plant & Machinery in audit period he should verify the invoice to that effect. He should check the Board Resolution authorizing Purchases of Plant & Machinery.
- If any machinery is disposed off and sold as scrap during the audit period, he should check the authorization and values report in that connection.
- He should check the rates and calculation of depreciation and ensure these are according to the provision of Section 205 of the Companies Act, 1956.
- He should check whether related expenses incurred on purchases of machinery are duly capitalized.
- He should check whether proper accounting of profit earned or loss suffered on Sale of Machinery, during the audit period, is done.
- If any machine is manufactured by the client itself, auditor should verify that capitalization of material, labor and other expenses is properly done.
- He should obtain from the Company management certificate about the verification of all items as required under CARO.
- He should scan the Plant register and physically inspect some of the major plants by visiting to the works.
- He should, finally, ensure appropriate disclosure of all information on the balance sheet as required by the Companies Act.
- He should obtain a certificate from the local auditor to that effect, if Plant and Machinery is kept abroad at a distant place.

**(iii) Freehold Land & Building**

- He should see that Freehold Land and Buildings are shown separately and not mixed with lease hold or other assets.
- He should see that separate accounts for land and for buildings are mentioned because on land usually no depreciation is provided.
- He should see that the balance shown on Balance Sheet is directly traceable from respective ledger account.
- He should examine the title deeds of the property and see that the asset is in the name of the client and in the free and fair possession of the client.
- He should examine that the title deed is genuine.
- The Purchases during the year be examined with the related correspondence, broker's note, auctioneer's note.
- In case of construction of the building auditor should examine the various certificates such as Builder's certificate, Contractor's certificates, Architect's certificate, Local authority certificate where needed.
- He should verify the sale, if a part of property has been sold during the period under audit.
- He should obtain a certificate from mortgagee if the property has been mortgaged and the deeds are with the mortgagee to verify the property.
- Land is not subject to depreciation but see that proper depreciation is provided on building as per the provision of Sec 205 of the Companies Act, 1956.

- See that the fluctuation in the value is not to be considered on Balance Sheet but if it has been considered then see that this is properly disclosed on Balance Sheet.
- Auditor should physically verify the existence of asset.

(b) **(i) Explain the features and Scope of an Internal Audit.** **[6]**

**Answer:**

Features of Internal Audit

- It is an independent appraisal activity within the organization.
- It can be conducted by the staff of the entity or by an independent professional appointed for that purpose.
- It is conducted for review of accounting, financial and other operations and controls established within an organization.
- It is conducted as a service to the organization and is not a part of the organization.
- It intends to furnish the analysis, appraisals, suggestions and information concerning the activities reviewed to the management.
- Internal auditing functions as a continuous effort for promoting effective control at cost reasonable cost.

Scope

The Institute of Internal Auditors defines scope of internal auditing as 'examination and evaluation of the adequacy and effectiveness of organisation's system of internal control and the quality of actual performance'. Therefore, internal auditing is concerned with an evaluation of both internal control as well as the quality of actual performance. According to the Institute, the scope of internal audit involves the following:

- Review the reliability and integrity of financial and operating information and the means to locate, identify, measure, classify and report such information.
- Appraise the economy and efficiency with which resources are employed.
- Review the systems established to ensure compliance with those policies, plans, procedures, laws and regulations which could have a significant effect and impact on operations and report, and should determine whether the organization is in compliance.
- Review the means of safeguarding assets and as appropriate verify the existence of such assets.
- Review operations or programs to ascertain whether results are consistent with established objectives and goals and whether the operations or programs are being carried out as planned.
- Internal auditing, therefore, is a function distinct from authorization and recording. It is concerned not only with examination of the transaction as recorded in the books of accounts but also with appraisal or procedure with a view to effecting change for better efficiency, where possible.

**(ii) What are the difference between Internal Audit and External Audit?** **[6]**

**Answer:**

Distinction between Internal Audit and External Audit

On accounting matters, the internal and external auditors operate mainly in the same field and they have a common interest in ascertaining that there is an effective system of internal control for presentation and detection of errors and frauds and to ensure that it is operating satisfactorily and that an adequate accounting system exists to provide the information necessary for preparing true and fair financial statements. There are some fundamental differences between the work of an internal auditor and that of an external auditor regarding the following:

- Appointment: The internal auditor is appointed by the management, generally the Directors and is responsible to them.
- The external or the statutory auditor is appointed according to the concerned statute. Generally, in case of company form of organization, the auditors are appointed by the shareholders in the annual general meeting.
- Scope: The extent of the work undertaken by the internal auditor is determined the management.
- The external auditor undertakes the area of the work which arises from the responsibilities placed on him by the governing statute.
- Approach: The internal auditor's approach is with a view to ensure that the accounting system is efficient, so that the accounting information presented to management throughout the period is accurate and discloses material facts.
- The external auditor's approach is governed by his responsibility to satisfy himself that the accounts to be presented to the shareholders show a true and fair view of the profit or loss for the financial period and of the company's state of affairs at the end of that period.
- Responsibility: The internal auditor's responsibility is to the management. It follows that the internal auditors, being a servant of the company, does not have independence of status.
- The external auditors, however, is responsible directly to the shareholders. Unlike the internal auditors, he is a representative of the shareholders and has independence of status.
- Objective: The main objective of internal audit is to ensure that the laid down policies, procedures and other internal control functions are functioning as designed.
- Whereas the objective of the external auditor is to express opinion and view to on financial statements whether those statements are showing true and fair view of the organisation.
- Independence: External auditor is more independent than internal auditor in the field of reporting.

Except these important differences, the work of both the internal auditor and the external auditor, on matters of accounting, is carried out largely by similar means, such as:

- Examination of the system of internal check, for both soundness and principle and effectiveness in operation.
- Examination and checking of accounting records and statements.
- Verification of assets and liabilities.
- Observations, inquiry, making of statistical comparisons and such other measures as may be judged necessary.

The wide experience of the external auditor may be of assistance to the internal auditor: while on the other side the latter's intimate acquaintance with business concern may be of help to the external auditors. Co-operation in planning of the respective auditors may save unnecessary works, although the external auditors must always satisfy himself as to the work carried out by the internal auditors.

**(c) (i) On the audit of Dreamlight Ltd. the audit partner of the engagement set the preliminary level of audit materiality at `12,00,000. After, the partner reviewed the audit of senior's assessment of inherent risk, he decided that the materiality level should be increased to `18,00,000.**

**Required:**

**A. What is the relationship between materiality and audit risk?**

**B. How will this new level of materiality affect the nature and extent of auditing procedures? [8]**

**Answer:**

**A.** The relationship between materiality and audit risk:

The concept of materiality is applied by the auditor both in planning and [redacted] and in evaluating the effect of identified misstatements on the audit [redacted] misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

In planning the audit, the auditor makes judgments about the size of misstatements that will be considered material. These judgments provide a basis for:

- Determining the nature, timing and extent of risk assessment procedures;
- Identifying and assessing the risks of material misstatement; and
- Determining the nature, timing and extent of further audit procedures.

In conducting an audit of financial statements, the overall objectives of the auditor are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and to report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings. The auditor obtains reasonable assurance by obtaining sufficient appropriate audit evidence to reduce audit risk to an acceptably low level. Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk. Materiality and audit risk are considered throughout the audit, in particular, when:

- Identifying and assessing the risks of material misstatement;
- Determining the nature, timing and extent of further audit procedures; and
- Evaluating the effect of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

**B.** The auditor shall revise materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) in the event of becoming aware of information during the audit that would have

caused the auditor to have determined a different amount (or amounts) initially (Initially `12,00,000 and revised at `18,00,000).

If the auditor concludes that a lower materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) than that initially determined is appropriate, the auditor shall determine whether it is necessary to revise performance materiality, and whether the nature, timing and extent of the further audit procedures remain appropriate.

Materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) may need to be revised as a result of a change in circumstances that occurred during the audit (for example, a decision to dispose of a major part of the entity's business), new information, or a change in the auditor's understanding of the entity and its operations as a result of performing further audit procedures. For example, if during the audit it appears as though actual financial results are likely to be substantially different from the anticipated period end financial results that were used initially to determine materiality for the financial statements as a whole, the auditor revises that materiality.

**(ii) Explain the difference between Qualified Report and Adverse Report.** **[4]**

**Answer:**

Distinguish Between Qualified Report and Adverse Report

| | Qualified Report | Adverse Report |
|---|---|---|
| i. | A Qualified Audit Report is one an Auditor gives an opinion subject to certain reservations. | An Adverse Report is given when the concludes that based on his examination, he does not agree with the affirmations made in the Financial Statements / Financial Report. |
| ii. | The Auditor's reservation is generally Stated as: "Subject to the above, we report that the Balance Sheet shows a true and fair view." | The Auditor states that the Financial Statements do not present a true and fair view of the state of affairs and working results of the organisation. |
| iii. | The accounts present a true and fair view subject to certain reservations. | The accounts do not present a true and fair view on the whole. |
| iv. | A Qualification is made in the Audit Report when the Auditor has reservation on specific item(s) of material nature. | An Adverse Report is given when the Auditor has his reservations on the true and fair view presented by the Financial Statements. |

# Paper 12 - Company Accounts & Audit

**Full Marks: 100**

## Section A

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

**(i) Differentiate between Reporting Currency and Foreign Currency.**

**Answer:**

Difference between Reporting Currency and Foreign Currency

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

**(ii) Define Financial Assets and Financial Liability as per AS 20.**

**Answer:**

Financial Asset: A Financial Asset is any asset that is –
(a) Cash
(b) A contractual right to receive cash or another Financial Asset from another Enterprise,
(c) A contractual right to exchange Financial Instruments with another Enterprise, under conditions that are potentially favorable, or
(d) An Equity Share of another Enterprise.

Financial Liability: A Financial Liability is any liability that is a contractual obligation –
(a) To deliver cash or another Asset to another Enterprise, or
(b) To exchange Financial Instruments with another Enterprise, under conditions that are potentially unfavourable.

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

**(a) Explain the objective of Financial Statements. [8]**

**Answer:**

Objective of Financial Statements

The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions. This would guide in deciding statements, their contents and disclosures.

A set of general purpose financial statements focus on financial position, performance and cash flows of an entity which could be used by any user group to assess investment decision,

employment stability or growth, debt servicing, business continuity and ability to make societal contribution. General purpose financial statements are those intended to meet the needs of users who are not in a position to require an entity to prepare reports tailored to their particular information needs.

A complete set of financial statements as worked out in Para 10 of IAS 1 is the outcome of the Framework which in turn is linked to subserve the information need of various user-groups. It comprises of:

(i) a statement of financial position as at the end of the period;

(ii) a statement of comprehensive income for the period ;

(iii) a statement of changes in equity for the period;

(iv) a statement of cash flows for the period;

(v) notes, comprising a summary of significant accounting policies and other explanatory information; and

(vi) a statement of financial position as at the beginning of the earliest comparative period when an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements.

Notes, comprising a summary of significant accounting policies and other explanatory information are important components of financial statements as they explain various elements of financial statements. Disclosure of risks adds to the information content of the financial statements.

Earning per share information contained in the Income Statement is focused information to shareholders as regards entity's performance. Information regarding diluted earning improves the information communique working out the effect of possible equity dilution actions. Similarly, segment reporting is intended to provide disaggregated information based on operating and / or geographic segments, consolidated financial statements focus on providing aggregated financial information for the entity-group as a whole, related party disclosures are intended to highlight non-market oriented transactions, if any. Thus the origination and improvement in disclosure and presentation standards have the purpose of making a set of general purpose financial statements useful to the diverse user-groups.

**(b) (i) Compute Basic Earnings Per Share from the following information –**

| Date | Particulars | No. of Shares |
|---|---|---|
| **1st April 2011** | **Balance at the beginning of the year** | **1,500** |
| **1st August 2011** | **Issue of Shares for Cash** | **600** |
| **31st March 2012** | **Buy back of Shares** | **500** |

**Net Profit for year ended 31st March 2012 was `2,75,000.** **[4]**

**Answer:**

1. Computation of Weighted Average Number of Shares outstanding during the period

| Date | No. of Equity share | Period Outstanding | Time Weighting factor | Weighted Avg. No. of Shares |
|---|---|---|---|---|
| (1) | (2) | (3) | (4) | (5)= (2) x (4) |
| 1st April 2011 | (Opening) 1,500 | 12 months | 12/12 | 1,500 |
| 1st August 2011 | (Fresh Issue) 600 | 8 months | 8/12 | 400 |
| 31st March 2012 | (Buy Back) 500 | 0 Months | 0/12 | - |

Weighted average Number of Equity Shares Outstanding during the period 1,900

2. Basic EPS = $\dfrac{\text{Net Profit or Loss attributable to Equity Shareholders}}{\text{Weighted Average Number of Equity shares Outstanding}}$

$= \dfrac{\text{` }2{,}75{,}000}{1{,}900 \text{ Shares}}$ = `144.74 per Share.

**(ii) Discuss the accounting treatment for Operating Leases in the Financial statements of Lessor. [4]**

**Answer:**

(a) Asset Recognition: The Lessor should present an Asset given under Operating Lease in its Balance Sheet under Fixed Assets.
(b) Income Recognition: Lease Income (excluding receipts for services provided, e.g. insurance and maintenance), should be recognised in the Statement of Profit and Loss on a Straight Line Basis over the Lease Term, even if it is not received on that basis, unless another systematic basis is more representative of the time pattern in which benefit derived from the use of the leased asset is diminished.
(c) Cost Recognition: Costs, including Depreciation, incurred in earning the Lease Income are recognised as an Expense.
(d) Initial Direct Costs: Initial Direct Costs incurred specifically to earn revenues are either - (a) deferred and allocated to income over the lease term in proportion [redacted] Rent Income, or (b) are recognised as an Expense in the Statement [redacted] period in which they are incurred.
(e) Depreciation: Depreciation of Leased Assets should be on a basis consistent with the normal depreciation policy of the Lessor for similar assets. The Depreciation charge should be calculated on the basis set out in AS - 6.
(f) Impairment Losses: The Lessor should apply AS - 28 to determine whether a Leased Asset has become impaired, and treat such impairment accordingly.
(g) Selling Profit: A Manufacturer or Dealer Lessor does not recognise any Selling Profit on entering into an Operating Lease, because it is not the equivalent of a sale.

**(c) Write short notes on recognition of Past Service Cost. [8]**

**Answer:**

1. Recognition as Expense:
   (a) In measuring its Defined Benefit Liability under Para 55, an Enterprise should recognise Past Service Cost as an expense, on a straight-line basis over the average period until the benefits become vested.
   (b) To the extent that the benefits are already vested immediately following the introduction of, or changes to, a Defined Benefit Plan, an enterprise should recognise Past Service Cost immediately.

   Example:

   An Enterprise operates a pension plan that provides a pension of 2% of final salary for each year of service. The benefits become vested after 5 years of service. On 1st January 20X4, the Enterprise improves the pension to 2.5% of final salary for each year of service starting from 1st January 20X0.

   Suppose, at the date of the improvement, the PV of the additional benefits for service from 1st Jan 20X0 to 1st January 20X4 is as follows -

| | |
|---|---|
| Employees with more than 5 years' service at 01.01.20X4 | `150 |
| Employees with less than 5 years' service at 01.01.20X4 | `120 |
| (Average period until vesting: 3 years) | |
| | `270 |

In this case, the Enterprise should recognise `150 immediately because those benefits are already vested. The Enterprise should recognise `120 on a straight-line basis over 3 years from 1st January 20X4.

2. Amendment of Amortisation Schedule: An Enterprise establishes the amortisation schedule for Past Service Cost when the benefits are introduced or changed. It would be impracticable to maintain the detailed records needed to identify and implement subsequent changes in that amortisation schedule. Also, the effect is likely to be material only where there is a curtailment or settlement. So, an Enterprise should amend the amortisation schedule for Past Service Cost, only if there is a curtailment or settlement.
3. Negative Past Service Cost: Where an Enterprise reduces benefits payable under an existing Defined Benefit Plan, the resulting reduction in the Defined Benefit Liability is recognised as (negative) Past Service Cost over the average period, until the reduced portion of the benefits becomes vested.
4. Net Change: Where an Enterprise reduces certain benefits payable under an existing Defined Benefit Plan and, at the same time, increases other benefits payable under the plan for the same employees, the Enterprise treats the change as a single net change.

# Section B

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

**(i) Explain the disclosure requirement of Deferred tax assets.**

**Answer:**

Deferred Tax Asset - Disclosure requirement

To be shown as a separate line item on the face of Balance Sheet.

**(ii) Explain the disclosure requirement of Intangible assets under development.**

**Answer:**

Intangible Assets under Development - Disclosure requirement

To be shown as a separate line item on the face of Balance Sheet.

Note - Intangible Assets under development should be disclosed under this head provided they can be recognized based on the criteria laid down in AS-26.

**(iii) What is meant by List B of Contributories?**

**Answer:**

a) Persons: Shareholders who had transferred Partly Paid Shares (otherwise than by operation of law or by death) within one year, prior to the date of winding up may be called upon to pay an

amount to pay off such Creditors as existed on the date of transfer of shares. These Transferors are called as B List Contributories.

b) Liability: Their liability is restricted to the amount not called up when the shares were transferred. They cannot be called upon to pay more than the entire face value of the share. For example, if Shares having Face Value of `100 were paid up `60, the B List Contributory can be called up to pay a maximum of `40 only.

c) Conditions: Liability of B List Contributories will crystallize only (a) when the existing assets available with the liquidator are not sufficient to cover the liabilities; (b) when the existing shareholders fail to pay the amount due on the shares to the Liquidator.

**(iv) What are the disclosure requirements of reportable segment under AS 17?**

**Answer:**

An enterprise should disclose the following for each reportable segment:

(a) segment revenue, classified into segment revenue from sales to external customers and segment revenue from transactions with other segments;

(b) segment result;

(c) total carrying amount of segment assets;

(d) total amount of segment liabilities;

(e) total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (tangible and intangible fixed assets);

(f) total amount of expense included in the segment result for depreciation and amortisation in respect of segment assets for the period; and

(g) total amount of significant non-cash expenses, other than depreciation and amortisation in respect of segment assets, that were included in segment expense and, therefore, deducted in measuring segment result.

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

**(a) On 1st April 2009, Gravity Ltd. issued 442, 10% Debentures of ` 1000 each at a discount of 10% redeemable at a premium of 5% after 4 years. It was decided to create a Sinking Fund for the purposes of accumulating sufficient funds to redeem the Debentures and to invest in some radily convertible securities yielding 10% interest p.a. Reference to the table shows that `1.00 p.a. at 10% compound interest amounts to `4.641 in 4 years. Investments are to be made in the Bonds of `1000 each available at par.**

**On 31st March 2013, the investments realised `3,40,000 and debentures were redeemed. The bank balance as on that date was `50,000.**

**Required: Prepare Debenture Redemption Fund Account and Debenture Redemption Fund Investments Account for 4 years. [16]**

**Answer:**

DRF = Debenture Redemption Fund, DRFI = Debenture Redemption Fund Investment

Dr. Discount on Issue of Debentures Account Cr.

| Date | Particulars | ` | Date | Particulars | ` |
|---|---|---|---|---|---|
| 31.03.10 | To Balance c/d | 1,00,000 | 31.03.10 | By P & L App. A/c | 1,00,000 |
| 31.03.11 | To Balance c/d | 2,10,000 | 01.04.10 | By Balance b/d | 1,00,000 |
| | | | 31.03.11 | By Interest on DRFI A/c | 10,000 |
| | | | | By P & L App. A/c | 1,00,000 |
| | | 2,10,000 | | | 2,10,000 |
| 31.03.12 | To Balance c/d | 3,31,000 | 01.04.11 | By Balance b/d | 2,10,000 |
| | | | | By Interest on DRFI A/c | 21,000 |
| | | | | By P & L App. A/c | 1,00,000 |
| | | 3,31,000 | | | 3,31,000 |
| 31.03.13 | To Loss on issue of Debentures (premium) | 22,100 | 01.04.12 | By Balance b/d | 3,31,000 |
| | To Debenture Redemption Reserve A/c | 4,52,000 | | By Interest on DRFI A/c | 33,100 |
| | | | | By P & L App. A/c | 91,000 |
| | | | | By Debenture [redacted] Investment A/c [redacted] | |
| | | 4,74,100 | | | 4,74,100 |

Dr. Debentures Redemption Fund Investment (DRFI) Account Cr.

| Date | Particulars | ` | Date | Particulars | ` |
|---|---|---|---|---|---|
| 31.03.10 | To Bank A/c | 1,00,000 | 31.03.10 | By Balance c/d | 1,00,000 |
| 01.04.10 | To Balance b/d | 1,00,000 | 31.03.11 | By Balance c/d | 2,10,000 |
| 31.03.11 | To Bank A/c | 1,10,000 | | | |
| | | 2,10,000 | | | 2,10,000 |
| 01.04.11 | To Balance b/d | 2,10,000 | 31.03.12 | By Balance c/d | 3,31,000 |
| 31.03.12 | To Bank A/c | 1,21,000 | | | |
| | | 3,31,000 | | | 3,31,000 |
| 01.04.12 | To Balance b/d | 3,31,000 | 31.03.13 | By Bank A/c (Sales) | 3,50,000 |
| 31.03.13 | To Debenture Redemption Fund A/c (Profit) | 9,000 | | | |
| | | 3,50,000 | | | 3,50,000 |

**Working Note:**

(i) Calculation of the amount of profit set aside

| | | ` |
|---|---|---|
| a. | Face Value of Debentures | 4,42,000 |

| | | |
|---|---|---|
| b. | Premium Payable on Redemption | 22,100 |
| c. | Depreciable Cost (A + B) | 4,64,100 |
| d. | Value of annuity per `1 | 4,641 |
| e. | Annual amount to be charged (C/D) | 1,00,000 |

(ii) Calculation of the amount of investments and interest

| Year | Opening Balance | Interest | Saving | Investments | Closing Balance |
|---|---|---|---|---|---|
| a | b | c = b×10/100 | d | e = c + d | f = b + e |
| 2009-10 | — | — | 1,00,000 | 1,00,000 | 1,00,000 |
| 2010-11 | 1,00,000 | 10,000 | 1,00,000 | 1,10,000 | 2,10,000 |
| 2011-12 | 2,10,000 | 21,000 | 1,00,000 | 1,21,000 | 3,31,000 |
| 2012-13 | 3,31,000 | 33,100 | 1,00,000 | — | — |

**(b) Given below is the Extract Trial Balance of Ramesh Ltd. and Dinesh Ltd. as on 31.3.2013. Dinesh Ltd. was merged with Ramesh Ltd. with effect from 01.04.2013.**

**Trial Balance (Extract) as on 31.3.2013 (`)**

| **Particulars** | **Ramesh Ltd.** | | **Dinesh Ltd.** | |
|---|---|---|---|---|
| | **Dr.** | **Cr.** | **Dr.** | **Cr.** |
| **Equity Shares of ` 10 each** | | **14,00,000** | | **5,00,000** |
| **General Reserve** | | **7,00,000** | | **2,40,000** |
| **Profit and Loss A/c** | | **4,20,000** | | **1,30,000** |
| **Export Profit Reserve** | | **1,40,000** | | **80,000** |
| **12% Debentures** | | **2,00,000** | | **2,00,000** |
| **Sundry Creditors** | | **80,000** | | **90,000** |
| **Provision for Taxation** | | **2,00,000** | | **1,20,000** |
| **Proposed Dividend** | | **2,80,000** | | **1,00,000** |
| **Sundry Fixed Assets (Tangible)** | **19,00,000** | | **8,00,000** | |
| **Investments (Non-trade)** | **4,00,000** | | **1,00,000** | |
| **Stock (opening)** | **2,40,000** | | **1,00,000** | |
| **Debtors** | **1,50,000** | | **1,60,000** | |
| **Advance Tax** | **1,60,000** | | **40,000** | |
| **Cash and Bank balances** | **5,50,000** | | **2,60,000** | |
| **Preliminary Expenses** | **20,000** | | | |
| **Total** | **34,20,000** | **34,20,000** | **14,60,000** | **14,60,000** |

**Closing Stock of Ramesh and Dinesh is also `2,40,000 & `1,00,000 respectively. Ramesh Ltd. would issue 12% Debentures to discharge the claims of the debenture holders of Dinesh Ltd. at par. Non-trade investments of Ramesh Ltd. fetched @ 25% while those of Dinesh Ltd. fetched @ 18%.**

**Profit (pre-tax) by Ramesh Ltd and Dinesh Ltd. during 2010-11, 2011-12 and 2012-13 and were as follows:**

| **Year** | **Ramesh Ltd.** | **Dinesh Ltd.** |
|---|---|---|
| | ` | ` |
| **2010-11** | **10,00,000** | **3,00,000** |
| **2011-12** | **13,00,000** | **4,20,000** |
| **2012-13** | **11,50,000** | **3,60,000** |

**Goodwill may be calculated on the basis of capitalisation method taking 20% as the pre-tax normal rate of return. Purchase consideration is discharged by Ram Ltd. on the basis of intrinsic value per share. Both companies decided to cancel the proposed dividend.**

**Required: Balance Sheet of Ramesh Ltd. after merger.** **[16]**

**Answer:**

WN # 1: Purchase Consideration:

| | | |
|---|---|---|
| (i) | Shares outstanding in Dinesh Ltd. | 50,000 |
| (ii) | Intrinsic Value per Share of Dinesh Ltd. [WN # 2] | ` 36.20 |
| (iii) | Value of Shares (a × b) | ` 18,10,000 |
| (iv) | Intrinsic value per share of Ramesh Ltd. [WN # 2] | ` 40.40 |

(v) No. of shares to be issued by Ramesh Ltd.

` 18,10,000/ ` 40.40 = 44,801.99

| Shares | Cash for fractions |
|---|---|
| 44,801 | 0.99 × 40.40 = 40 |

(iv) Purchase consideration

(a) 44,801 shares @ 40.40

| | | |
|---|---|---|
| Capital [`10 / Share] | 4,48,010 | |
| Premium [`30.40 / Share] | 13,61,950 | = 18,09,960 |
| (b) Cash for fractional shares | | = 40 |
| (c) Total purchase consideration payable | | = 18,10,000 |

WH # 2: Intrinsic Value per share:

(`)

| | | | Ramesh Ltd. | | Dinesh Ltd. |
|---|---|---|---|---|---|
| (i) | Assets | | | | |
| (a) | Goodwill | 27,30,000 | | 7,60,000 | |
| (b) | Sundry Fixed assets | 19,00,000 | | 8,00,000 | |
| (c) | Investments | 4,00,000 | | 1,00,000 | |
| (d) | Stock | 2,40,000 | | 1,00,000 | |
| (e) | Debtors | 1,50,000 | | 1,60,000 | |
| (f) | Advance Tax | 1,60,000 | | 40,000 | |
| (g) | Cash and Bank Balance | 5,50,000 | 61,30,000 | 2,60,000 | 22,20,000 |
| (ii) | Liabilities | | | | |
| (a) | 12% Debentures | 2,00,000 | | 2,00,000 | |

| | | | | | |
|---|---|---|---|---|---|
| | (b) Sundry creditors | 80,000 | | 90,000 | |
| | (c) Provision for tax | 2,00,000 | (4,80,000) | 1,20,000 | (4,10,000) |
| (iii) | Net Assets (i-ii) | | 56,50,000 | | 18,10,000 |
| (iv) | No. of Outstanding Shares | | 1,40,000 | | 50,000 |
| (v) | Intrinsic Value per share (iii)/(iv) | | 40.40 | | 36.20 |

W # 3: Valuation of Goodwill

A. Capital Employed

| | | Ramesh Ltd. | | Dinesh Ltd. | |
|---|---|---|---|---|---|
| (i) | Assets: | | | | |
| | (a) Sundry Fixed assets | 19,00,000 | | 8,00,000 | |
| | (b) Investment (Non-trade) | - | | - | |
| | (c) Stock | 2,40,000 | | 1,00,000 | |
| | (d) Debtors | 1,50,000 | | 1,60,000 | |
| | (e) Advance tax | 1,60,000 | | 40,000 | |
| | (f) Cash and Bank balance | 5,50,000 | 30,00,000 | 2,60,000 | 13,60,000 |
| (ii) | Liabilities: | | | | |
| | (a) 12% Debentures | 2,00,000 | | [redacted] | |
| | (b) Sundry creditors | 80,000 | | 90,000 | |
| | (c) Provision for tax | 2,00,000 | 4,80,000 | 1,20,000 | 4,10,000 |
| (iii) | Capital Employed: (i) - (ii) | | 25,20,000 | | 9,50,000 |

B. Average Pre-tax Profit:

| Particulars | | Ramesh Ltd. | Dinesh Ltd. |
|---|---|---|---|
| (i) | 2010-11 | 10,00,000 | 3,00,000 |
| (ii) | 2011-12 | 13,00,000 | 4,20,000 |
| (iii) | 2012-13 | 11,50,000 | 3,60,000 |
| (iv) | Total (a+b+c) | 34,50,000 | 10,80,000 |
| (v) | Simple Average [(iv)/3] | 11,50,000 | 3,60,000 |
| (vi) | Less: Non-trading income | (1,00,000) | (18,000) |
| (vii) | Average pre-tax profit | 10,50,000 | 3,42,000 |

C. Computation of Goodwill:

| Particulars | | Ramesh Ltd. | Dinesh Ltd. |
|---|---|---|---|
| | | ` | ` |
| a. | Capitalised value of average profits | | |
| | $\frac{10,50,000}{0.20}; \frac{3,42,000}{0.20}$ | 52,50,000 | 17,10,000 |
| b. | Capital Employed | 25,20,000 | 9,50,000 |
| c. | Goodwill (a-b) | 27,30,000 | 7,60,000 |

Journal Entries - Books of Ramesh Ltd.

- Nature of Amalgamation – PURCHASE
- Method of Accounting – PURCHASE METHOD

| | Particulars | | Debit | Credit |
|---|---|---|---|---|
| a. | For Business Purchase : | | | |
| | Business Purchase A/c | Dr. | 18,10,000 | |
| | To Liquidator of Dinesh Ltd. A/c | | | 18,10,000 |
| b. | For Assets and Liabilities taken over | | | |
| | Goodwill A/c | Dr. | 7,60,000 | |
| | Fixed Assets A/c | Dr. | 8,00,000 | |
| | Investments A/c | Dr. | 1,00,000 | |
| | Stock A/c | Dr. | 1,00,000 | |
| | Debtors A/c | Dr. | 1,60,000 | |
| | Advance tax A/c | Dr. | 40,000 | |
| | Cash and Bank A/c | Dr. | 2,60,000 | |
| | To 12% Debenture holders A/c | | | 2,00,000 |
| | To Creditors A/c | | | 90,000 |
| | To Provision for Taxation A/c | | | [redacted] |
| | To Business Purchase A/c | | | [redacted] |
| c. | For Discharge of Purchase Consideration: | | | |
| | Liquidator of Dinesh Ltd. | Dr. | 18,10,000 | |
| | To Equity Share capital A/c | | | 4,48,010 |
| | To Securities premium A/c | | | 13,61,950 |
| | To Cash A/c | | | 40 |
| d. | Contra Entry | | | |
| | Amalgamation Adjustment A/c | Dr. | 80,000 | |
| | To Export Profit Reserve A/c | | | 80,000 |

Name of the Company: Ramesh Ltd.

Balance Sheet as at 31.03.2013

| Ref No. | Particulars | Note No. | As at 31st March, 2013 ` | As at 31st March, 2012 ` |
|---|---|---|---|---|
| I. | Equity and Liabilities | | | |
| 1 | Shareholders' funds | | | |
| | (a) Share capital | 1 | 18,48,010 | |
| | (b) Reserves and surplus | 2 | 29,81,950 | |
| | (c) Money received against share warrants | | | |
| 2 | Share application money pending allotment | | | |
| 3 | Non-current liabilities | | | |

| | | | |
|---|---|---|---|
| | (a) Long-term borrowings | 3 | 4,00,000 |
| | (b)Deferred tax liabilities (Net) | | |
| | (c) Other Long term liabilities | | |
| | (d) Long-term provisions | | |
| 4 | Current Liabilities | | |
| | (a) Short-term borrowings | | |
| | (b) Trade payables | 4 | 1,70,000 |
| | (c) Other current liabilities | | |
| | (d) Short-term provisions | 5 | 3,20,000 |
| | Total (1+2+3+4) | | 57,19,960 |
| II. | Assets | | |
| 1 | Non-current assets | | |
| | (a) Fixed assets | | |
| | (i) Tangible assets | 6 | 27,00,000 |
| | (ii) Intangible assets | 7 | 7,60,000 |
| | (iii) Capital work-in-progress | | |
| | (iv) Intangible assets under development | | |
| | (b) Non-current investments | 8 | 5,00,000 |
| | (c) Deferred tax assets (Net) | | |
| | (d) Long-term loans and advances | 9 | 2,00,000 |
| | (e) Other non-current assets | 10 | 80,000 |
| 2 | Current assets | | |
| | (a) Current investments | | |
| | (b) Inventories | 11 | 3,40,000 |
| | (c) Trade receivables | 12 | 3,10,000 |
| | (d) Cash and cash equivalents | 13 | 8,09,960 |
| | (e) Short-term loans and advances | | |
| | (f) Other current assets | 14 | 20,000 |
| | Total (1+2) | | 57,19,960 |

Note to the Accounts:-

`

| Note 1. Share Capital | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Authorised, Issued, Subscribed and Paid up Share Capital 1,84,801 Equity Shares of `10 each (of which 44,801 shares were issued for consideration other than cash) | 18,48,010 | |
| Total | 18,48,010 | |

| Note 2. Reserves and Surplus | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Securities Premium | 13,61,950 | |
| General Reserve | 7,0[redacted] | |
| Profit and Loss A/c `4,20,000<br>Add: Proposed Dividend Cancelled `2,80,000 | 7,00,000 | |
| Export Profit reserve (1,40,000+80,000) | 2,20,000 | |
| Total | 29,81,950 | |

| Note 3. Long-term borrowings | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| 12% Debentures of `100 each (2,00,000+2,00,000) | 4,00,000 | |
| Total | 4,00,000 | |

| Note 4. Trade Payables | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Sundry Creditors (80,000 + 90,000) | 1,70,000 | |
| Total | 1,70,000 | |

| Note 5. Short term Provisions | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Provision for Tax (2,00,000 + 1,20,000) | 3,20,000 | |
| Total | 3,20,000 | |

| Note 6. Tangible Assets | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Sundry Fixed assets (19,00,000 + 8,00,000) | 27,00,000 | |
| Total | 27,00,000 | |

| Note 7. Intangible assets | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Goodwill | 7,60,000 | |
| Total | 7,60,000 | |

| Note 8. Noncurrent Investments | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Investment (4,00,000 + 1,00,000) | 5,00,000 | |
| Total | 5,00,000 | |

| Note 9. Long-term Loans and advances | As at 31st March, [redacted] | As at 31st [redacted] |
|---|---|---|
| Advance Tax (1,60,000 + 40,000) | 2,00,000 | |
| Total | 2,00,000 | |

| Note 10.Other Non-current assets | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Amalgamation Adjustment A/c | 80,000 | |
| Total | 80,000 | |

| Note 11. Inventories | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Stock (2,40,000 + 1,00,000) | 3,40,000 | |
| Total | 3,40,000 | |

| Note 12. Trade receivables | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Debtors (1,50,000 +1,60,000) | 3,10,000 | |
| Total | 3,10,000 | |

| Note 13. Cash and Cash Equivalents | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Cash and Bank balance (5,50,000 + 2,60,000 - 40) | 8,09,960 | |
| Total | 8,09,960 | |

| Note 14. Other Current Assets | As at 31st March, 2013 | As at 31st March, 2012 |
|---|---|---|
| Preliminary Expenses | 20,000 | |
| Total | 20,000 | |

(c) **The following is the Extract Trial Balance of "Tarun Ltd". as on 30.09.2012: (Amount in `)**

| Particulars | | Dr. | Cr. |
|---|---|---|---|
| **11% Preference Shares of `10 each** | | | **2,00,000** |
| **20,000 Equity Shares of `10 each, fully paid** | | | **2,00,000** |
| **10,000 Equity Shares of ` 10 each, ` 7.50 paid** | | | **75,000** |
| **13% Debentures** | | | **3,00,000** |
| **Mortgage Loan** | | | **1,60,000** |
| **Bank Overdraft** | | | [redacted] |
| **Creditors for Trade** | | | [redacted] |
| **Arrears of Income tax (Assessments concluded in July 2004)** | | | |
| **Assessment Year 2010-2011 -** | **42,000** | | |
| **Assessment Year 2011-2012 -** | **10,000** | | **52,000** |
| **Land and Building** | | **2,40,000** | |
| **Sundry Current Assets** | | **7,90,000** | |
| **Profit & Loss Account** | | **77,000** | |
| **Debenture Issue expenses not written off** | | **4,000** | |
| **Total** | | **11,11,000** | **11,11,000** |

**Other Information**

- **Mortgage Loan was secured against Land and Buildings. Debentures were secured by a Floating Charge on all the other assets.**
- **The Company was unable to meet the payments and therefore the Debenture holders appointed a Receiver and this was followed by a resolution for Members Voluntary Winding Up.**
- **The Receiver for the Debenture holders brought the Land and Buildings to auction and realized `3,00,000. He also took charge of Sundry Assets of the value of `4,80,000 and realized `4,00,000.**
- **The Liquidator realized `2,00,000 on the sale of the balance of Sundry Current Assets.**
- **The Bank Overdraft was secured by a personal guarantee of two of the Directors of the Company and on the Bank raising a demand, the Directors paid off the dues from their personal resources.**
- **Costs incurred by the Receiver were ` 4,000 and by the Liquidator ` 5,600.**

- **The Receiver was not entitled to any remuneration but the Liquidator was to receive 3% Fee on the value of assets realized by him.**
- **Preference Shareholders had not been paid dividend for the period after 30.9.2010 and interest for the last half-year was due to Debenture holders.**

**From the above information, prepare the Liquidator's Receipts and Payments Account. [16]**

**Answer:**

Determination of Surplus received by Liquidator from Receiver

| Receipts | ` | Payments | ` |
|---|---|---|---|
| Land and Buildings | 3,00,000 | Debenture Interest (3,00,000 x 13% x 6/12) | 19,500 |
| Sundry Current Assets | 4,00,000 | Income Tax Arrears (42,000 + 10,000) | 52,000 |
| | | Expenses of Receiver Given | 4,000 |
| | | Mortgage Loan Given | 1,60,000 |
| | | Debenture holders Principal Amount | 3,00,000 |
| | | Balance Surplus handed over to [redacted] (b/f) | |
| Total | 7,00,000 | | 7,00,000 |

Liquidator's Receipts & Payments Account

| Receipts | ` | Payments | | ` |
|---|---|---|---|---|
| Surplus received from Receiver (WN 1) | 1,64,500 | Remuneration to Liquidator (2,00,000 x 3%) | | 6,000 |
| | | Cost of Liquidation | | 5,600 |
| Sundry Assets realized | 2,00,000 | Unsecured Creditors: | | |
| Calls on Contributories | 21,700 | - Trade Creditors | 64,000 | |
| - From 10,000 Partly Paid Shares at ` 2.17 per share (See WN 3 below) | | - Directors (for Bank Overdraft paid) | 60,000 | 1,24,000 |
| | | Preference Shareholders: | | |
| | | - Share Capital | 2,00,000 | |
| | | - Arrears of Dividend (2 yrs) | 44,000 | 2,44,000 |
| | | Equity Shareholders' Final Payment | | |
| | | - Return of money to holders of 20,000 Fully Paid Shares at ` 0.33 each | | 6,600 |
| Total | 3,86,200 | Total | | 3,86,200 |

Calls from Holders of Partly Paid Shares

| | Particulars | ` |
|---|---|---|
| a. | Total of Receipts before considering Call Money (1,64,500 + 2,00,000) | 3,64,500 |
| b. | Total Payments before final payment to Equity Shares (5,600 + 6,000 + 1,24,000 + 2,44,000) | 3,79,600 |
| c. | Deficit from above from Calls made on Equity Shares (a-b) | (15,100) |
| d. | Notional Call on 10,000 Partly Paid Shares at ` 2.50 each | 25,000 |
| e. | Surplus Cash Balance after Notional Call (comparing c and d) | 9,900 |
| f. | Number of Shares deemed fully paid (20,000 + 10,000) | 30,000 |
| g. | Hence, Refund on Fully Paid Shares ` 9,900 / 30,000 Shares (e ÷ f) | 33 paise |
| h. | Therefore, Required Call on Partly Paid Shares (2.50 – 0.33) | ` 2.17 |

# Section C

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

**(i) State the advantages of Social audit.**

**Answer:**

Advantages of Social audit

- Encourages community participation among different business entities.
- Ensures continuous efforts towards environmental protection and use of environment friendly production processes.
- Builds customer satisfaction and trust through ethical business practices.
- Promotes collective decision making and sharing responsibilities.
- Develops human resources by working towards improvement of workers' and the underprivileged persons' working/ living conditions.

**(ii) Explain the difference between a checklist and an Internal Control questionnaire.**

**Answer:**

Difference between a checklist and an Internal Control questionnaire

| S. No | Basis | Check List | Internal Control Questionnaire |
|---|---|---|---|

| | | | |
|---|---|---|---|
| a. | Point of Time | It is issued at the commencement of audit and reported back after completion of audit. | It can be issued at any point of time and reported back immediately. |
| b. | Issued To | It is issued to the audit staff to be followed by them during audit and reported back at completion. | It is issued to various people at different levels in the organization. |
| c. | Contents | It contains instructions to be followed by audit assistants. | It contains questions to be answered by the employees of the organization. |
| d. | Objective | It works as a guideline for audit staff so that no area remains unchecked | This is used to collect the information to know about the internal control system and evaluate the weaknesses therein. |

**(iii) Explain the difference between Test Check and Statistical Sampling.**

**Answer:**

Difference between Test Checking and Statistical Sampling

| S.No. | Basis | Test Checking | Statistical Sampling |
|---|---|---|---|
| a. | Selection | Selective transactions are verified. | Drawing a sample from a large number of transactions. |
| b. | Technique | No specific technique is used. | Statistical technique used is: selection on random basis. |
| c. | Subjective | It is subjective and depends upon the choice of the auditor. | It depends upon the statistical technique applied. |
| d. | Risk& Method | It involves more risk as there are no specific methods for test check. | It carries lesser risk and various statistical methods can be used at different times. |

**(iv) What types of analysis are covered by analytical procedures?**

**Answer:**

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

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

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

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

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

**(i) What are the matters should be considered by the auditor of the company while doing audit of Charitable Institutions? [8]**

**Answer:**

When conducting the audit of a charitable institution, the auditor should consider the following matters:

- The auditor should study the constitution of the charitable institution, fo[redacted] is set up under the Societies Registration Act or as per section 25 of the [redacted] a trust.
- Obtain a list of members of the governing body. This will help the auditor in identifying whether any of the members of the governing body has any interest in the charitable institution.
- The auditor should obtain a copy of the budget sanctioned or the financial statement. This would enable him to acquaint himself with the different heads of income and expenditures of incomes and expenditures of the institution.
- Examination of the system of internal check, especially as regards the accounting of the amounts collected.
- Check that the amounts received towards income have been duly collected, received and deposited into the bank regularly and promptly.
- These institutions receive subscriptions and donations which form the major part of their collections. Therefore the auditor should check the following:
- The amount or the rate of the annual subscription.
- Any instructions given by the donors as to the specific utilization of donation.
- Adequacy of internal controls existing as regards unused receipt books, counter foils, etc.
- Where subscriptions are received in advance these should be properly dealt with in the accounts.
- Verify the amounts of legacies received by reference to correspondence with any figures and other available informations.
- Where the institution has made any investments or given loans, the amount of dividend and interest should be properly vouched with reference to the counterfoils or dividend warrants

received. It should be ensured that such loans or grants are given under proper authorizations.

- If some property is given or taken on rent, then the auditor should check the tenancy agreement, the rent slips and the authorized person for the collection or payment, as the case may be, of the rent.
- Most of the organisations organize special functions such as concert etc. The auditor should be careful in such cases. All the gross receipts and outgoings are to be properly vouched by him. It should be ensured that proper internal check was maintained as regards the receipts and outgoings. For example, the person responsible for collection and disbursements should be separate persons.
- The expenditure of charitable institution is also one of the major areas of concern. Thus the auditor should verify that the expenditure is made only for the charitable purpose. If the expenditure is not for the charitable purpose, then the auditor should examine the implications of applicable law and document for the same.
- The auditor should physically verify the cash in hand, inventories and fixed assets.

**(ii) What are the scope of Audit Committee of the company?**

**Answer:**

An Audit Committee consists of three to five members formed to serve as communication link among various departments. Audit Committee has a fourfold relationship and therefore has to interact with management, internal auditor, statutory auditor and the public.

The Scope of Audit Committee can be discussed as follows: -

- Review of annual financial statements before submission to the Board of Directors.
- Selection of the Statutory Auditor
- Act as lies on between the Statutory Auditor and Board of Directors
- Administrative control of the internal control functions through the feedback between the Internal Auditor and the Audit Committee.
- Over seeing internal central operation.
- Over seeing internal audit operations and feedback between internal audit committee and developing the internal auditing authority through broad based internal audit programming.
- Review and approval of financial information for publication
- Review proposed changes in accounting system and procedures.
- Help resolve differences between management, internal and statutory auditor.
- Report on the audit committee acting in the Annual Reports of Board of Directors.
- Ensure reliability of organisation's financial statements and operational activities. To be effective and purposeful, the audit committee should maintain the following:-

- Audit Committee should have the independence of management, Statutory Auditor and Internal Auditor. The Board of Directors allows full freedom to the audit committee to investigate into any areas of operation.
- The relation between the audit committee and management should be cordial and congenial towards optimum efficiency and healthy growth of the organization.
- There should be a regular line of communication through occasional meetings with the management.
- There should be good communication relationship interwoven among management, internal auditor and statutory auditor.

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

(a) **How to verify the following –** **[3x4 = 12]**
**(i) Verification of Contingent Liability**
**(ii) Verification of Plant & Machinery**
**(iii) Freehold Land & Building**

**Answer:**
(i) Verification of Contingent Liability

Auditor should carefully verify contingent liabilities as it may become actual liability on happening or not happening certain events and while verifying keep in mind following points.

- Obtain certificate about the contingent liabilities disclosed in the Balance Sheet, from a responsible officer.
- Carefully examine whether such liabilities are in existence or not.
- Check relevant documents to confirm the existence of contingent liability.
- Verify the certified list given by responsible officer to ascertain whether there exists any contingent liability which may turn to be an actual liability.
- Verify whether proper provision is made or not for the contingent liability turned out to be an actual liability.
- Verify bill discounting register, investment register, minute book and other relevant records to establish the amount of contingent liability.
- See whether contingent liability is properly disclosed in the Balance Sheet.

**(ii) Verification of Plant & Machinery**

As in case of industrial concern out of total assets 20% to 50% cost is that of Plant & Machinery and hence the auditor is required to take much more precaution while verifying the Plant and Machinery and for this he should give attention to following points-

- He should get the detailed list of all Plant and Machineries and asset wise accumulated depreciation.
- He should trace the opening balance in the Plant & Machinery register with the help of last year's audited balance sheet.

- He should verify quotations, invoices, cost etc., in connection with Purchase of Plant & Machinery. If there are sales of Plant & Machinery in audit period he should verify the invoice to that effect. He should check the Board Resolution authorizing Purchases of Plant & Machinery.
- If any machinery is disposed off and sold as scrap during the audit period, he should check the authorization and values report in that connection.
- He should check the rates and calculation of depreciation and ensure these are according to the provision of Section 205 of the Companies Act, 1956.
- He should check whether related expenses incurred on purchases of machinery are duly capitalized.
- He should check whether proper accounting of profit earned or loss suffered on Sale of Machinery, during the audit period, is done.
- If any machine is manufactured by the client itself, auditor should verify that capitalization of material, labor and other expenses is properly done.
- He should obtain from the Company management certificate about the verification of all items as required under CARO.
- He should scan the Plant register and physically inspect some of the major plants by visiting to the works.
- He should, finally, ensure appropriate disclosure of all information on the balance sheet as required by the Companies Act.
- He should obtain a certificate from the local auditor to that effect, if Plant and Machinery is kept abroad at a distant place.

**(iii) Freehold Land & Building**

- He should see that Freehold Land and Buildings are shown separately and not mixed with lease hold or other assets.
- He should see that separate accounts for land and for buildings are mentioned because on land usually no depreciation is provided.
- He should see that the balance shown on Balance Sheet is directly traceable from respective ledger account.
- He should examine the title deeds of the property and see that the asset is in the name of the client and in the free and fair possession of the client.
- He should examine that the title deed is genuine.
- The Purchases during the year be examined with the related correspondence, broker's note, auctioneer's note.
- In case of construction of the building auditor should examine the various certificates such as Builder's certificate, Contractor's certificates, Architect's certificate, Local authority certificate where needed.
- He should verify the sale, if a part of property has been sold during the period under audit.
- He should obtain a certificate from mortgagee if the property has been mortgaged and the deeds are with the mortgagee to verify the property.
- Land is not subject to depreciation but see that proper depreciation is provided on building as per the provision of Sec 205 of the Companies Act, 1956.

- See that the fluctuation in the value is not to be considered on Balance Sheet but if it has been considered then see that this is properly disclosed on Balance Sheet.
- Auditor should physically verify the existence of asset.

(b) **(i) Explain the features and Scope of an Internal Audit.** **[6]**

**Answer:**

Features of Internal Audit

- It is an independent appraisal activity within the organization.
- It can be conducted by the staff of the entity or by an independent professional appointed for that purpose.
- It is conducted for review of accounting, financial and other operations and controls established within an organization.
- It is conducted as a service to the organization and is not a part of the organization.
- It intends to furnish the analysis, appraisals, suggestions and information concerning the activities reviewed to the management.
- Internal auditing functions as a continuous effort for promoting effective control at cost reasonable cost.

Scope

The Institute of Internal Auditors defines scope of internal auditing as 'examination and evaluation of the adequacy and effectiveness of organisation's system of internal control and the quality of actual performance'. Therefore, internal auditing is concerned with an evaluation of both internal control as well as the quality of actual performance. According to the Institute, the scope of internal audit involves the following:

- Review the reliability and integrity of financial and operating information and the means to locate, identify, measure, classify and report such information.
- Appraise the economy and efficiency with which resources are employed.
- Review the systems established to ensure compliance with those policies, plans, procedures, laws and regulations which could have a significant effect and impact on operations and report, and should determine whether the organization is in compliance.
- Review the means of safeguarding assets and as appropriate verify the existence of such assets.
- Review operations or programs to ascertain whether results are consistent with established objectives and goals and whether the operations or programs are being carried out as planned.
- Internal auditing, therefore, is a function distinct from authorization and recording. It is concerned not only with examination of the transaction as recorded in the books of accounts but also with appraisal or procedure with a view to effecting change for better efficiency, where possible.

**(ii) What are the difference between Internal Audit and External Audit?** **[6]**

**Answer:**

Distinction between Internal Audit and External Audit

On accounting matters, the internal and external auditors operate mainly in the same field and they have a common interest in ascertaining that there is an effective system of internal control for presentation and detection of errors and frauds and to ensure that it is operating satisfactorily and that an adequate accounting system exists to provide the information necessary for preparing true and fair financial statements. There are some fundamental differences between the work of an internal auditor and that of an external auditor regarding the following:

- Appointment: The internal auditor is appointed by the management, generally the Directors and is responsible to them.
- The external or the statutory auditor is appointed according to the concerned statute. Generally, in case of company form of organization, the auditors are appointed by the shareholders in the annual general meeting.
- Scope: The extent of the work undertaken by the internal auditor is determined the management.
- The external auditor undertakes the area of the work which arises from the responsibilities placed on him by the governing statute.
- Approach: The internal auditor's approach is with a view to ensure that the accounting system is efficient, so that the accounting information presented to management throughout the period is accurate and discloses material facts.
- The external auditor's approach is governed by his responsibility to satisfy himself that the accounts to be presented to the shareholders show a true and fair view of the profit or loss for the financial period and of the company's state of affairs at the end of that period.
- Responsibility: The internal auditor's responsibility is to the management. It follows that the internal auditors, being a servant of the company, does not have independence of status.
- The external auditors, however, is responsible directly to the shareholders. Unlike the internal auditors, he is a representative of the shareholders and has independence of status.
- Objective: The main objective of internal audit is to ensure that the laid down policies, procedures and other internal control functions are functioning as designed.
- Whereas the objective of the external auditor is to express opinion and view to on financial statements whether those statements are showing true and fair view of the organisation.
- Independence: External auditor is more independent than internal auditor in the field of reporting.

Except these important differences, the work of both the internal auditor and the external auditor, on matters of accounting, is carried out largely by similar means, such as:

- Examination of the system of internal check, for both soundness and principle and effectiveness in operation.
- Examination and checking of accounting records and statements.
- Verification of assets and liabilities.
- Observations, inquiry, making of statistical comparisons and such other measures as may be judged necessary.

The wide experience of the external auditor may be of assistance to the internal auditor: while on the other side the latter's intimate acquaintance with business concern may be of help to the external auditors. Co-operation in planning of the respective auditors may save unnecessary works, although the external auditors must always satisfy himself as to the work carried out by the internal auditors.

**(c) (i) On the audit of Dreamlight Ltd. the audit partner of the engagement set the preliminary level of audit materiality at `12,00,000. After, the partner reviewed the audit of senior's assessment of inherent risk, he decided that the materiality level should be increased to `18,00,000.**

**Required:**

**A. What is the relationship between materiality and audit risk?**

**B. How will this new level of materiality affect the nature and extent of auditing procedures? [8]**

**Answer:**

**A.** The relationship between materiality and audit risk:

The concept of materiality is applied by the auditor both in planning and [redacted] and in evaluating the effect of identified misstatements on the audit [redacted] misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

In planning the audit, the auditor makes judgments about the size of misstatements that will be considered material. These judgments provide a basis for:

- Determining the nature, timing and extent of risk assessment procedures;
- Identifying and assessing the risks of material misstatement; and
- Determining the nature, timing and extent of further audit procedures.

In conducting an audit of financial statements, the overall objectives of the auditor are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and to report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings. The auditor obtains reasonable assurance by obtaining sufficient appropriate audit evidence to reduce audit risk to an acceptably low level. Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk. Materiality and audit risk are considered throughout the audit, in particular, when:

- Identifying and assessing the risks of material misstatement;
- Determining the nature, timing and extent of further audit procedures; and
- Evaluating the effect of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

**B.** The auditor shall revise materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) in the event of becoming aware of information during the audit that would have

caused the auditor to have determined a different amount (or amounts) initially (Initially `12,00,000 and revised at `18,00,000).

If the auditor concludes that a lower materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) than that initially determined is appropriate, the auditor shall determine whether it is necessary to revise performance materiality, and whether the nature, timing and extent of the further audit procedures remain appropriate.

Materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) may need to be revised as a result of a change in circumstances that occurred during the audit (for example, a decision to dispose of a major part of the entity's business), new information, or a change in the auditor's understanding of the entity and its operations as a result of performing further audit procedures. For example, if during the audit it appears as though actual financial results are likely to be substantially different from the anticipated period end financial results that were used initially to determine materiality for the financial statements as a whole, the auditor revises that materiality.

**(ii) Explain the difference between Qualified Report and Adverse Report. [4]**

**Answer:**

Distinguish Between Qualified Report and Adverse Report

| | Qualified Report | Adverse Report |
|---|---|---|
| i. | A Qualified Audit Report is one an Auditor gives an opinion subject to certain reservations. | An Adverse Report is given when the concludes that based on his examination, he does not agree with the affirmations made in the Financial Statements / Financial Report. |
| ii. | The Auditor's reservation is generally Stated as: "Subject to the above, we report that the Balance Sheet shows a true and fair view." | The Auditor states that the Financial Statements do not present a true and fair view of the state of affairs and working results of the organisation. |
| iii. | The accounts present a true and fair view subject to certain reservations. | The accounts do not present a true and fair view on the whole. |
| iv. | A Qualification is made in the Audit Report when the Auditor has reservation on specific item(s) of material nature. | An Adverse Report is given when the Auditor has his reservations on the true and fair view presented by the Financial Statements. |