Paper – 12: Company Accounts and Audit

Full Marks: 100 **Time Allowed: 3 Hours**

This paper contains 4 questions. All questions are compulsory, subject to instruction provided against each question. All workings must form part of your answer. Assumptions, if any, must be clearly indicated.

1. **Answer all questions:** **[2×10=20]**

(a) What we understand by the term "Reliability"?

Answer:

An information is reliable if it is –

- Free from material error and bias and
- Presented faithfully which it either purports to represent or could reasonably be expected to represent.

(b) Exchange Rate

Goods purchased on 24.3.13 of US $1,00,00	**₹46.60**
Exchange rate on 31.3.13	**₹47.00**
Date of actual payment 5.6.14	**₹47.50**

Calculate the loss/gain for the financial years 2012-13 and 2013-14.

Answer:

As per AS-11, all foreign currency transactions should be recorded by applying the exchange rate at the date of transaction. Therefore, goods purchased on 24.3.13 and corresponding creditor would be recorded at ₹46.60.
= 1,00,000 x 46.60 = 46,60,000
As per AS-11, at the balance sheet date all monetary items should be reported using the closing rate. Therefore, the creditors of US $1,00,000 outstanding on 31.3.13 will be reported as:
= 1,00,000 x 47.00 = 47,00,000
Exchange loss ₹40,000 = (47,00,000 – 46,60,000) should be debited in profit and loss account for 2012-13.
As per AS-11, exchange difference on settlement on monetary items should be transferred to profit and loss account as gain or loss thereof:
=1,00,000 x 47.50=47,50,000 -47,00,000 = ₹50,000 should be debited to profit or loss for the year 2013-14.

(c) A company is planning to raise funds by making right issue of equity shares to finance its expansion. The existing equity share capital of the company is ₹50,00,000. The market value of its share is ₹42. The company offers to its shareholders the right to buy 2 shares at ₹11 each for every 5 shares held. Calculate theoretical market price of one share after right issue.

Answer:

Market value of 5 shares already held by a shareholder @ ₹42 = ₹210
Add: Price to be paid by him for acquiring 2 shares @₹11 each = ₹22
Total price of 7 shares after right issue = ₹232

Therefore, Theoretical market price of one share = ₹232/7=₹33.14

(d) What is the meaning of the expression 'cash equivalent'?

Answer:

Cash equivalent means bank balance and other risk free short-term investments and advances which are readily encashable. Cash equivalents means short-term highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value.

(e) List the accounts/reserves whose profit is not available for payment of dividend.

Answer:

The accounts/reserves whose profits are not allowed for payment of dividend are:
(i) Securities Premium Account
(ii) Forfeited Shares Account
(iii) Profit prior to incorporation
(iv) Capital Reserve
(v) Development rebate reserve

(f) Goodwill arising on acquisition as per AS-14 is to be treated as per AS-26. Comment.

Answer:

An Intangible Asset acquired in the course of an amalgamation in the nature of purchase, is accounted for in accordance with AS-14. The Transferee Company should recognize an Intangible Asset meeting the recognition criteria under AS – 26, even if such asset had not been recognized in the Financial Statement of the Transferor Company.

(g) State the uses of Interim Audit.

Answer:

Interim Audit is useful for:
- Early detection and rectification of errors and frauds
- Publishing of interim results in some cases
- Timely completion of records and final audit
- Moral checks on employees

(h) What do you mean by the term "Tolerable Error"?

Answer:

Tolerable error is the maximum error in the population that the auditor would be willing to accept and still concludes that the result from the sample has achieved the audit objective. Tolerable error is considered during the planning stage and, for substantive procedures, is related to the auditor's judgement about materiality. The smaller the tolerable error, the greater the sample size will need to be. In tests of control, the tolerable error is the maximum rate of deviation from a prescribed control procedure that the auditor would be willing to accept, based on the preliminary assessment of control risk. In substantive procedures, the tolerable error is the maximum monetary error in an account balance or class of transactions that the auditor would be willing to accept so that when the results of all audit procedures are considered, the auditor is able to conclude, with reasonable assurance, that the financial statements are not materially misstated.

(i) List the quality control procedures to be adopted at the individual audit level.

Answer:

The procedures of quality control are the responsibility of the audit firm. The firm has an obligation to establish and maintain a system of quality control to provide it with reasonable assurance.
The system of quality control includes procedures that address each of the following elements:
• Leadership responsibilities for quality within the firm;
• Relevant ethical requirements;
• Acceptance and continuance of client relationships and specific engagements;
• Human resources;
• Engagement performance; and
• Monitoring.

(j) Define 'Opinion Paragraph' of the Auditors' Report.

Answer:

The Opinion paragraph of the Auditors' Report should indicate the Financial Reporting framework used to prepare the Financial Statements. It should state the Auditor's opinion as to whether the Financial Statements give a true and fair view in accordance with the financial reporting framework and where appropriate, whether the financial statements comply with the statutory requirements.

2. (Answer any 2 questions)

(a) (i) List the five criteria that an auditor must adhere to claim that the financial statements are fairly presented in accordance with GAAP. [5]

Answer:

The five criteria are:

- The accounting principles selected and applied have general acceptance.
- The accounting principles are appropriate in the circumstances.
- The financial statements, including the related notes are informative of matters that may affect their use, understanding and interpretation.
- The information presented in the financial statements is classified and summarized in a reasonable manner, that is, it is not too detailed nor too condensed.
- The financial statements reflect the underlying transactions and events in a manner that presents the financial position, results of operations and cash flows, stated within a range of acceptable limits.

(ii) Guri Ltd. took a factory premises on lease on 01.04.11 for ₹2,00,000 per month. The lease is operating lease. During March, 2012, Guri Ltd. relocates its operation to a new factory building. The lease on the old factory premises continues to be live upto 31.12.2014. The

lease cannot be cancelled and cannot be sub-let to another user. The auditor insists that lease rent of balance 33 months upto 31.12.2014 should be provided in the accounts for the year ending 31.03.2012. What should Guri Ltd. do? [3]

Answer:

As per AS-29 'Provisions, Contingent Liabilities and Contingent Assets', if an enterprise has a contract that is onerous, the present obligation under the contract should be recognized and measured as a provision. [For a contract to qualify as an onerous contract, the unavoidable costs of meeting the obligation under the contract should exceed the economic benefits expected to be received under it.]In the given case, the operating lease contract has become onerous as the economic benefit of lease contract for the next 33 months up to 31.12.2014 will be nil. However, the lessee, Guri Ltd., has to pay lease rent of ₹66,00,000(i.e. 2,00,000 p.m. for next 33 months)

(b) (i) AD Ltd. received a revenue grant of ₹1000 lakhs during the year 2011-12 from Government for welfare activities to be carried on by the company for its employees. The grant prescribed the condition for utilization, however during 2013-14 it was found that the condition of grant was not complied with and the grant had to be refunded to the Government. How this refund should be shown in the financial statement for the year 2013-14? [2]

Answer:

As per AS-12 Govt. grants that become refundable should be accounted for as an extraordinary item as per AS-5. Therefore, refund of grant should be shown in the Profit and Loss Statement of the company as an extraordinary item during the year 2013-14.

(ii) The following information is available in respect of Rise Ltd. for the accounting year 2012-13 and 2013 -14:

Net profit for		**₹**
Year	**2012-13**	**22,00,000**
Year	**2013-14**	**30,00,000**

Number of shares outstanding prior to right issue 10,00,000 shares.

Right issue: One new share for each five shares outstanding i.e. 2,00,000 shares.

: Right issue price ₹ 25

: Last date to exercise right 31st July, 2013.

Fair value of one equity share immediately prior to exercise of rights on 31.07.2013 is ₹ 32.

You are required to compute:

(i) Basic earnings per share for the year 2012-13.

(ii) Restated basic earnings per share for the year 2012-13 for right issue.

(iii) Basic earnings per share for the year 2013-14. [6]

Answer:

(ii) Computation of basic earnings per share

	Year 2012-13 (₹)	Year 2013-14 (₹)
EPS for the year 2012-13 as originally reported = Net profit for the year attributable to equity share holders/ weighted average number of equity shares outstanding during the year = ₹22,00,000/10,00,000 shares	2.20	
EPS for the year 2012-13 restated for the right issue = ₹ 22,00,000 / (10,00,000 x 1.04)	2.12	
EPS for the year 2013-14 (including effect of right issue) = ₹ 30,00,000 / {(10,00,000 x 1.04 x 4/12) + (12,00,000x8/12)}		2.62

Working Notes:

1. Computation of theoretical ex-rights fair value per share = (fair value of all outstanding shares immediately prior to exercise of rights +Total value received from exercise of rights)/ (number of shares outstanding prior to exercise + number of shares issued on the exercise)

   = (₹ 32 x 10,00,000 + ₹ 25 x 2,00,000) / (10,00,000 + 2,00,000) = ₹ 30.83

2. Computation of adjustment factor

   = Fair value per share prior to exercise of rights / Theoretical ex-right value per share

   = ₹ 32/ ₹ 30.83 = 1.04 (approx.)

(c) (i)A pharma company spent ₹35 lakhs during the accounting year ended 31.03.2013 on research project to develop a drug to treat 'AIDS'. Experts are of the view that it may take four years to establish whether the drug will be effective or not, and even if found effective, it may take two or three more years to produce the medicine, which can be marketed. The company wants to treat the expenditure as deferred revenue expenditure. Comment. [6]

Answer:

As per AS-26, an intangible asset arising from development (or from the development phase of an internal project) should be recognized if, and only if, an enterprise can demonstrate all of the following:

- The technical feasibility of completing the intangible asset so that it will be available for use or sale
- Its intention to complete the intangible asset and use or sell it
- Its ability to use or sell the intangible asset.
- How the intangible asset will generate probable future economic benefits. Among other things, the enterprise should demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.

- The availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset and
- Its ability to measure the expenditure attributable to the intangible asset during its development reliably.

  From the above it becomes clear in this case that it is not possible for the company to satisfy all the above conditions and hence the entire amount of the expenditure should be treated as expense when it is incurred. In short, no intangible asset arising from research (or from research phase of an internal project) should be recognized. So expenditure on research should be recognized as an expense when it is incurred.

(ii) Define Contingent Rent as per AS-19. [2]

Answer:

Lease rent fixed on the basis of percentage of sales, amount of usage, price indices, market rate of interest is called contingent rent. In other words, lease rent is not fixed, but it is based on a factor other than time.

3. (Answer any 2 questions)

(a) (i) P company issued 1,50,000 shares of ₹10 each at a premium of ₹10.The entire issue was underwritten as follows:
X – 90,000 shares (Firm Underwritten 12,000 shares)
Y – 37,500 shares (Firm Underwritten 4,500 shares)
Z – 22,500 shares (Firm Underwritten 15,000 shares)
Total Subscriptions received by the company (excluding Firm Underwriting and Marked Applications) were 22,500 shares.The marked applications (excluding Firm Underwriting) were as follows:
X – 15,000 shares
Y – 30,000 shares
Z – 7,500 shares
Commission Payable to Underwriters is at 5% of the Issue Price. The Underwriting contract provides that credit for Unmarked Applications be given to the Underwriters in proportion to the shares underwritten, and benefit of Firm Underwriting is to be given to Individual Underwriters.
Required:
- **Determine the Liability of each Underwriter (Number of Shares)**
- **Compute the amounts payable or due from Underwriters. [8]**

Answer:

Underwriters' Liability [No. of shares] and amount due from Underwriters

Particulars	X	Y	Z	Total
Gross Liability	90,000	37,500	22,500	1,50,000
Less: Marked Application	(15,000)	(30,000)	(7,500)	(52,500)
Less: Unmarked Applications [0.6:0.25:0.15]	(13,500)	(5,625)	(3,375)	(22,500)
Less: Firm Underwriting	(12,000)	(4,500)	(15,000)	(31,500)
Net Liability under the contract	49,500	(2,625)	(3,375)	43,500

Adjust: Surplus of Y and Z transferred to X	(6,000)	2,625	3,375	Nil
Balance to be underwritten	43,500	—	—	43,500
Add: Firm Underwriting	12,000	4,500	15,000	31,500
Total Liability=shares to be taken up by underwriters	55,500	4,500	15,000	75,000
Amount due to company at ₹20 per share (₹)	11,10,000	90,000	3,00,000	15,00,000
Less:Commission due to Underwriters [Gross Liability x (20 x 5%)] (₹)	(90,000)	(37,500)	(22,500)	(1,50,000)
Amount receivable from Underwriters (₹)	10,20,000	52,500	2,77,500	13,50,000

(ii) The position of a company on its liquidation is as under:

1. **Issued and Paid Up Capital:**
   2,000 11% preference Shares of ₹100 each fully paid.
   2,000 Equity Shares of ₹100 each fully paid.
   1,500 Equity Shares of ₹50 each, ₹30 per share paid.
2. **Calls in Arrear are ₹5,000 whereas calls received in advance is ₹4000.**
3. **Preference Dividends are in arrear for one year.**
4. **Amount left with the liquidator after discharging all liabilities is ₹3,01,000.**
5. **The Company's Articles provide for payment of arrear Preference Dividends in priority to return of Equity Capital.**

You are required to prepare the Liquidator's Final Statement of Accounts, with the above information. [8]

Answer:

Liquidator's Final Statement of Accounts

Receipts	₹	Payments	₹
Cash in Hand (given)	3,01,000	Calls in Advance refund(given)	4,000
Calls in Arrears (given)	5,000	Arrear of Preference Dividend at 11% on 2,00,000	22,000
		Preference Share Capital	2,00,000
		Equity Share Capital-on 2,000 Fully paid up shares at ₹40 (bal fig.)	80,000
	3,06,000		3,06,000

	₹
Total of receipts before considering Call Money (3,01,000 +5,000)	3,06,000
Total payments before final payment to equity shares (4,000 + 22,000+ 2,00,000)	2,26,000
Surplus / (deficit) from above before calls made on Equity Shares	80,000
Notional call on 1,500 pertly paid shares at ₹20 each ₹(50 – 30)	30,000
Surplus Cash Balance after Notional Call	1,10,000
Total amount of equity share capital, after Notional call [(2,000 x100) + (1,500 x 50)]	2,75,000
Percentage of payment possible to Equity Shareholders (1,10,000/2,75,000)	40%
Hence, Deficiency Percentage (100%-40%)	60%
Deficiency per ₹100 paid up share= ₹60,	₹60 & ₹30

Deficiency per ₹50 paid up share =₹30	
Amount refundable for ₹100 paid up share = ₹(100-60)	₹40

Call Adjustments:

- Calls in Advance is to be refunded since the loss on partly paid up share is just ₹30, the amount paid up.
- Calls in Arrears ₹5000 is to be collected.
- Notional Call is applied only on Partly paid shares and not on already fully paid up shares of different Nominal Values.

(b) (i) A Ltd.had issued 11% 5,00,000 debentures of ₹100 each redeemable on 31st March 2014 at a premium of 5%.
The company offered three options to debenture holders as under:

i. **13% Preference shares of ₹10 each at ₹10.50**
ii. **14% debentures of ₹100 at par.**
iii. **Redemption in cash.**

The options were accepted as under.
Option i. By holders of 1,00,000 debentures.
Option ii. By holders of 1,00,000 debentures.
Option iii. By holders of 3,00,000 debentures.
The company carried out the redemption. Pass the necessary journal entries. [4]

Answer:

Date	Particulars	Dr. ₹ in lakhs	Cr. ₹ in lakhs
	11 % Debentures A/c Dr. Premium on redemption of debentures A/c Dr. To Debenture Holder A/c	500 25	 525
	Debenture Holder A/c Dr. To 13% Preference share capital account To Securities premium account	105	 100 5
	Debenture Holder A/c Dr. To 14% Debentures A/c	105	 105
	Debenture Holder A/c Dr. To Bank A/c	315	 315

(ii) List the expenses that are not included in Segment expense as per AS-17. [5]

Answer:

Segment expense does not include:

- Extraordinary items as defined in AS-5, Net Profit or Loss for the period, Prior Period items and changes in Accounting Policies,
- Interest expense, including interest incurred on advances or loans from other segments, unless operations of the segment are primarily of a financial nature.

- Losses on sales of investments or losses on extinguishment of debt unless the operations of the segment are primarily of a financial nature.
- Income tax expense
- General administrative expenses, head-office expenses, and other expenses that arise at the enterprise level and relate to the enterprise as a whole. However, cost are sometimes incurred at the enterprise level on behalf of a segment. Such costs are part of segment expense if they relate to the operating activities of the segment and if they can be directly attributed or allocated to the segment on a reasonable basis.

(ii) Rana Limited was incorporated on August 1, 2013. It had acquired a running business of Rana & Co. with effect from April 1, 2013. During the year 2013-14, the total sales were ₹36,00,000.The sales per month in the first half year were half of what they were in the later half year. The net profit of the company, ₹2,00,000 was worked out after charging the following expenses:
(i) Depreciation ₹1,23,000, (ii) Director's fees ₹50,000, (iii) Preliminary Expenses ₹12,000, (iv) office expenses ₹78,000, (v) Selling Expenses ₹72,000 and (vi) Interest to vendors upto August 31, 2013 ₹5,000.
Please ascertain pre-incorporation and post-incorporation profit for the year ended 31st March, 2014. [7]

Answer:

Statement showing pre and post incorporation profit for the year ended 31st March, 2014

Particulars	Total Amount	Basis of Allocation	Pre-incorporation	Post-incorporation
Gross Profit	5,40,000	2:7	1,20,000	4,20,000
Less: Depreciation	1,23,000	1:2	41,000	82,000
Director's fees	50,000	Post	—	50,000
Preliminary Expenses	12,000	Post	—	12,000
Office Expenses	78,000	1:2	26,000	52,000
Selling Expenses	72,000	2:7	16,000	56,000
Interest to vendors	5,000	Actual	4,000	1,000
Net Profit (₹33,000 being pre-incorporation profit is transferred to capital reserve account)	2,00,000		33,000	1,67,000

Working Notes:

1. Sales ratio – The sales per month in the first half year were half of what they were in the later half year. If in the later half year, sales per month is `1 then it should be 50 paise per month in the first half year. So sales for the first four months (i.e. from 1st April, 2013 to 31st July,2013) will be 4 x 0.50 = ₹2 and for the last eight months (i.e. from 1st August, 2013 to 31st March, 2014) will be (2 x0.50+6 x 1)=₹7. Thus sales ratio is 2:7.
2. Time Ratio
   1st April,2013 to 31st July,2013 : 1st August,2013 to 31st March,2014 = 1:2
3. Gross Profit = Net Profit + All Expenses
   = ₹(2,00,000 +3,40,000) = ₹5,40,000

(c) (i) List the conditions to be satisfied for Amalgamation in the nature of merger. [6]

Answer:

Amalgamation in nature of merger is an amalgamation, which satisfies all the following conditions:

- All the assets and liabilities of the transferor company become the assets and liabilities of the transferee company,
- Shareholders holding not less than 90% of the face value of the equity shares of the transferor company (other than transferee company and its nominees) become equity shareholders of the transferee company after amalgamation,
- The consideration is to be discharged by way of issue of equity shares in the transferee company to the shareholders of the transferor company on the amalgamation,
- The business of the transferor company is to be carried on by the transferee company,
- No adjustments are intended to be made to the book values of the assets and liabilities of the transferor company.

If any one or more of the aforesaid conditions are not satisfied then the amalgamation is in nature of purchase.

(ii) The following is the Balance Sheet of Astar Ltd. as at 31.03.2013

Liabilities	Amount (₹ in Lakhs)
10% Redeemable Pref. Shares of ₹ 10 each, fully paid	2,500
Equity Shares of ₹10 each, fully paid	8,000
Capital Redemption Reserve	1,000
Securities Premium	800
General Reserve	6,000
Profit and Loss A/c	300
9% Debentures	5,000
Sundry Creditors	2,300
Sundry Provisions	1,000
	26,900

Assets	Amount (₹ in Lakhs)
Fixed Assets	14,000
Investments	3,000
Cash at Bank	1,650
Other Current Assets	8,250
	26,900

On 1st April, 2013 the company redeemed all of its preference shares at a premium of 10% and bought back 25% of its equity shares @ ₹ 20 per share. In order to make cash available, the company sold all the investments for ₹ 3,150 lakh and raised a bank loan amounting to ₹ 2,000 lakhs on the security of the company's plant.

Pass Journal Entries for all the above mentioned transactions including Cash transactions. The amount of securities premium has been utilised to the maximum extent allowed by law. [10]

Answer:

In the books of Astar Ltd. Journal Entries

Particulars		₹ in Lakhs	
		Amount	Amount
Bank A/c To, Investments To, Profit and Loss A/c (Being sale of investments and profit thereon)	Dr.	3,150	 3,000 150
Bank A/c To, Bank Loan A/c (Being loan taken from bank)	Dr.	2,000	 2,000
10% Redeemable Pref. Share Cap A/c Premium on Redemption of Pref. Shareholder A/c To, Preference Shareholder A/c (Being redemption of Preference shares)	Dr. Dr.	2,500 250	 2,750
Preference Shareholders A/c To, Bank A/c (Being payment of amount due to Pref. Shareholders)	Dr.	2,750	 2,750
Securities Premium A/c To, Premium on Red. of Pref. Shares A/c (Being use of Securities premium to provide premium on red. of preference shares)	Dr.	250	 250
Equity Share Capital A/c Securities Premium (800 - 250) A/c General Reserve A/c To, Equity Shareholders (Being buy back of Equity Shares) **Note:** General Reserve Balance (6,000 - 1450) = ₹ 4,550	Dr. Dr. Dr.	2,000 550 1,420	 4,000
General Reserve A/c To, Capital Redemption Reserve A/c (Being creation of capital redemption reserve to the extent of the face value of preference share redeemed and equity shares bought back)	Dr.	4,500	 4,500
Equity Shareholders A/c To, Bank A/c (Being payment of amount due to Equity Shareholders)	Dr.	4,000	 4,000

Note: Cash at Bank = (1,650 + 3,150 + 2,000 - 2,750 - 4,000) = ₹ 50

4. (Answer any 2 questions)

(a) (i) 'Both audit and investigation involve a systematic and critical examination of the available evidence,yet these are quiet distinct from each other.'- Justify. [7]

Answer:

It is to be noted that both auditing and investigation have a fact finding character. Both involve a systematic and critical examination of the available evidence, yet these are quiet distinct from each other as follows:

(i) Meaning - Auditing is an independent and systematic examination of the evidence underlying the accounting or other data in accordance with the generally accepted auditing practices to ascertain the true and fair view of the financial statements of an enterprise. An investigation may be defined as an examination of accounts and records with a view to ascertain any fact for some special purpose which varies from assignment to assignment.

(ii) Scope - The audit has a wide scope. In statutory audit, the scope is determined by the relevant law and in case of a private audit (e.g. management audit) by a client. The scope of investigations, on the other hand, is limited as regards the period or areas to be covered.

(iii) Objective - In audit, the accounts and records are verified as to their truth and fairness, whereas, investigation is for special purpose (e.g. investigation on the behalf of incoming partner

(iv) Audit Procedure - The audit is conducted in accordance with the generally accepted auditing procedure but investigations involve an extended auditing procedure.

(v) Evidence - An investigator can draw his conclusions only on the basis of substantial or sometimes conclusive evidence while an auditor will evaluate the accounting records predominantly based on persuasive evidence.

(vi) Approach - Auditor is skeptical and not suspicious whereas an investigator starts with suspicion and collects evidence to either confirm or dispel that suspicion.

(vii) Periodicity - Auditing is a routine exercise (normally conducted annually) but the investigations may spread over a period longer than one year.

(ii) 'An independent opinion by the statutory auditor increases the reliability, authenticity and credibility of the Financial Statements which may further be used by different users for various purposes.'- List the purposes. [9]

Answer:

An independent opinion by the auditor increases the reliability, authenticity and credibility of the Financial Statements which may further be used by different users for various purposes such as:

(i) The members/shareholders/stakeholders, for their economic decisions and for exercising their voting rights.

(ii) For timely tax assessments.

(iii) For determining the purchase or sale consideration in case of ongoing concern.

(iv) Settlement of partners' accounts in case of admission, retirement or death of partner on account of goodwill or otherwise.

(v) Before the court, in case of settlement of disputes with employees, creditors or debtors.

(vi) For determining the actual value of business or shares in case of merger, acquisition, etc.

(vii) For getting financial assistance from financial institutions, banks or investors.

(viii) In case of non-profit organizations, for getting government grants and availing tax exemptions.

(ix) Evaluation of the internal control systems and strengthening it by removing the inherent weaknesses, and checking the efficacy of the internal checks.

(x) For checking the integrity of the management which manages the funds and affairs on behalf of the real owners or shareholders.

(xi) For other users of financial statements like creditors, investors and government agencies, it ensures that any assertions in the Financial Statements are neither overstated/understated nor misrepresented.

(xii) For the proper distribution of profits by way of payment of wages and other benefits.

(xiii) For ensuring of proper distribution of profits as dividends.
(xiv) For ensuring that all legal requirements are fulfilled and statutory compliances are met.
(xv) For settlement of insurance claims or other recoveries from government bodies or otherwise.

(b) (i) List the precautions that the auditor must take before he applies test checking for auditing. [6]

Answer:

The auditor must take the following precautions before he applies test checking for auditing:
i) The auditor must review the system of internal controls existing in the enterprise. Test checking should be avoided in case the internal control system is weak or ineffective.
ii) The sample selected for test checking should be representative in character and the transactions should be of homogeneous nature.
iii) The number of transactions to be selected for test checking should be predetermined depending upon the extent to which the reliance can be placed on the results of test checking.
iv) The auditor should identify those areas where test checking is not suitable, for example, opening and closing entries, bank reconciliation statement, non-recurring items, transactions of a seasonal industry, other areas where the compliance with the applicable law is required such as managerial remuneration under Companies Act, etc.
v) No element of bias should be present in selecting a sample.
vi) The system of test checking should be reviewed from time to time so that necessary improvements, if any, can be made.

(ii) 'An effective system of internal control should have some basic elements.'- Discuss. [7]

Answer:

An effective system of internal control should have the following basic elements:
1. Financial and other Organizational Plans: This may take the form of manual suitably classified by flow charts. It should specify the various duties and responsibilities of both management and staff, stating the powers of authorisation that reside with various members. This is important as in the event of staff absence or otherwise the correct flow of work and the internal control system could be vitiated by any wrong implementation of procedures by staff either unintentionally or willfully.
2. Competent Personnel: In any internal control system, personnel are the most important element. When the employees are competent and efficient in their assigned work, the internal control system can be worked and operated efficiently and effectively even if some of the other elements of the internal control system are absent.
3. Division of Work: this refers to the procedure of division of work properly among the employees of the organization. Each and every work of the organization. Each and every work of the organization should be divided in different stages and should be allocated to the employees in accordance with quality and skill.
4.Separation of operational responsibility from record keeping: If each department of an organization is being assigned to prepare its own records and reports, there may be a tendency to manipulate results for showing better performance. So in order to ensure reliable records and information, recordkeeping function is separated from the operational responsibility of the concerned department.
5. Separation of the custody of assets from accounting: To protect against misuse of assets and their misappropriation, it is required that the custody of assets and their accounting should be done by separate persons. When a particular person performs both the functions, there is a

chance of utilizing the organisation's assets for his personal interest and adjusting the records to relieve himself from the responsibility of the assets.
6. Authorization: In a internal control system, all the activities must be authorized by a proper authority. The individual or group which can grant either specific or general authority for transactions should hold a position commensurate with the nature and significance of the transactions and the policy for such authority should be established by the top management.
7. Managerial supervision and review: The internal control system should be implemented and maintained in conformity with the environmental and elemental changes of the concern. By adapting any specific control system permanently, the extent to which the procedures of flexible controls have been followed in real practice should be observed and re-examined.

(iii) List the general principles of vouching as well as auditing. [3]

Answer:

The general principles of vouching as well as auditing can be listed as under:
i. Genuineness
ii. Accuracy
iii. Authenticity
iv. Authorization
v. Classification
vi. Disclosure

(c) (i) State the procedure that an auditor has to follow for timely detection of teeming and lading. [6]

Answer:

Teeming & Lading is a commonly followed method of misappropriation of cash by concealing cash shortages and covering them through recoveries from another customer.

The auditor has to follow the following procedure for timely detection of teeming and lading:
i. Ascertain if the Cash Memos are consecutively numbered, and the dates, name and amount as per the Daily Summary reconcile with relevant cash receipt records.
ii. Reconcile individual cash amounts as per receipts with records in the Rough Cash Book.
iii. Reconcile the receipts as recorded in the Rough Cash Book, main Cash Book, pre-numbered Cash Memos, with counterfoils of the pay-in-slips.
iv. Ensure whether cash receipts are deposited in the bank on a timely basis.
v. Examine the Debtors Ledger, especially entries showing part payments, to satisfy that the debtors concerned have indeed made part payments.
vi. Confirmations may be obtained from the debtors from time to time.

(ii) Discuss the disqualification of company auditor under section 226(3) of Companies Act,1956. [6]

Answer:

Section 226 (3) provides that none of the following persons shall be qualified for appointment as auditor of a company
(a) A body corporate;
(b) An officer or employee of the company;
(c) A person who is a partner, or who is in the employment, of an officer or employee of the company;

(d) A person who is indebted to the company or has given any guarantee or provided any security in connection with the indebtedness of any third person to the company for amount exceeding ₹1000;
(e) A person holding any security of that company after a period of one year W.E.F. 13.12.2000.
A person who is disqualified as above is also disqualified for appointment to be an auditor of
(A) it's holding Company
(B) it's subsidiary company
(C) a subsidiary of its holding company. – Sec 226. (4)
If an Auditor becomes subject, after his appointment, to any of the disqualifications specified in subsection (3) and (4), he shall be deemed to have vacated his office as such. - Sec 226. (5)
It may be notes that if an auditor already holds appointment as auditor in the specified number or more of companies as per section 224(1B), he will be disqualified for being appointed as an auditor of any other company.

(iii) List the objectives and functions of the Auditing and Assurance Standard Board. [4]

Answer:

The objectives and functions of the Auditing and Assurance Standard Board are:

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