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) The carrying amount of an asset given on sale and leaseback that results in an operating lease is ₹20,000. The fair value and the selling price of the asset at inception of the lease is ₹18,000. Give the accounting treatment in the books.

Answer:

Loss of ₹2,000 (₹20,000 - ₹18,000) to be immediately recognized in the profit and Loss account.

(b) 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.

(c) An entity has granted mobilisation advance to the contractors amounting to ₹40 lacs. How should the entity classify this advance as current and non-current?

Answer:

The entity shall refer to the estimated billing schedule of the contractor against which the advance will be adjusted. Accordingly, it shall project the recovery schedule of the advance. The portion of the advance which is projected to be adjusted within 12 months after the reporting date is classified as current and the balance is classified as non-current.

(d) Foreign currency creditors at the end of the financial year are USD 10 Lakhs. Purchase were recorded at the exchange rate USD 1= ₹62. On the balance sheet date, the exchange rate is USD 1 = ₹64 which is not expected to be payable on the payment date. It has been estimated that around the payment time, the exchange rate will possibly be in the range of USD 1 - ₹65.00 to ₹66.50. At what value should the creditors be recorded in the balance sheet? What is the treatment of foreign exchange loss?

Answer:

Creditors should be recorded at the expected payable value, i.e. Average Expected Rate = (₹65.00 + ₹66.50) ÷ 2 = ₹65.75 per USD. The amount of creditors recognized in the B/S shall be ₹65.75 x 10 Lakhs USD = ₹657.50 Lakhs.

Treatment of foreign exchange loss -

The Exchange Loss of (₹65.75 – ₹62) x 10 Lakhs USD = ₹37.50 Lakhs should be recognized as loss in the Profit & Loss account.

(e) The share capital of M Ltd. consists of 1,00,000 equity shares of ₹10 each, and 25,000 preference shares of ₹100 each, fully called up. Besides, its securities premium account shows a balance of ₹40,000 and general reserve of ₹7,00,000. The company decides to buy-back 30,000 equity shares of ₹12 each. For this purpose, it utilises the securities premium in full and general reserve to the extent necessary.

Pass the necessary journal entries only showing the effects on the securities premium account and the general reserve account.

Answer:

Journal Entries

Particulars	Dr. (₹)	Cr.(₹)
Equity Share Capital A/c Dr. Securities Premium A/c Dr. General Reserve A/c Dr. To, Equity Shareholders A/c (Being the amount due to equity shareholders for buying-back of 30,000 equity shares)	3,00,000 40,000 20,000	 3,60,000
General Reserve A/c Dr. To, Capital Redemption Reserve A/c (Being the nominal amount or equity shares bought back transferred)	3,00,000	 3,00,000

(f) Journalise the following transaction:

FD Ltd. issued 8,000 shares of ₹100 each credited as fully paid to the promoters for their services.

Answer:

Journal Entry

Particulars	L.F.	Dr. (₹)	Cr.(₹)
Goodwill A/c Dr. To, Share Capital A/c [Being the issue of 8,000 shares of ₹100 each at par to promoters as per Board's Resolution dated…..]		8,00,000	 8,00,000

(g) Discuss the disadvantages of surprise checks in an audit.

Answer:

Disadvantages of surprise checks in an Audit are -

(i) It allows little time for preparation and development of a site visit protocol. More time will be expanded on-site in understanding the program elements.
(ii) It typically requires a longer site visit to cover the same issues as an announced visit.
(iii) It has a greater potential to create conflicts.
(iv) Personnel required for evaluation and interview may not be available.

(h) 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.

(i) According to Sec 227(1) of the Companies Act, 1956, the auditor can call for any explanations or information from the officers and employees of the company. Is it true? Give reason.

Answer:

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

(j) Discuss the necessity of Continuous Audit.

Answer:

Continuous audit is necessary where:
i. Internal controls are inadequate.
ii. The transactions run in large numbers.
iii. The management is interested in getting statements of accounts audited periodically for enabling better management of resources.

2. (Answer any 2 questions)

(a) (i) List the rate of exchange to be adopted for translation of the following items while translating the financial statement of a non-integral foreign operation:

- **Depreciation;**
- **Salaries and wages;**
- **Opening Stock;**
- **Closing Stock;**
- **Debtors;**
- **Fixed assets (these were acquired out of funds raised from issue of equity shares);**
- **Accounts payable;**
- **Provision for taxes.** **[4]**

Answer:

The translation of the financial statements of an Integral foreign operation involves the following step

- Depreciation – Rate used for respective Fixed Assets.
- Salaries and wages – Average Rate
- Opening Stock – Opening Rate
- Closing Stock – Closing Rate
- Debtors – Closing Rate
- Fixed assets (these were acquired out of funds raised from issue of equity shares) – Closing Rate
- Accounts payable – Closing rate
- Provision for taxes – Closing Rate

(ii) X Ltd. sold its plant to Y Ltd. (a lease financer). The written down value of the plant in X Ltd.'s book is ₹100 million and selling price is ₹120 million. The plant is taken back on lease.

What are the accounting issues involved? **[4]**

Answer:

Issues involved in this kind of sale and leaseback transactions are:

(I) Lease classification: The transaction shall be classified as finance lease or operating lease considering the lease term and applying the lease classification criteria.

(II) Accounting for profit/loss on sale of asset by the seller cum lessee: It would depend upon lease classification. Accounting treatment is different if the lease is classified as finance lease or operating lease.

(III) Accounting by the buyer cum lessor: The buyer cum lessor classifies the lease applying lease classification criteria of AS 19. He will account for the finance lease using purchase price as the fair value of the asset at the inception of lease and taking into account the agreed upon lease rent, guaranteed/unguaranteed residual value, contingent rent etc. In case the lease is classified as an operating lease, he will apply principles of operating lease accounting by lessor.

(b) Calculate the basic and diluted EPS:

(i) Income after tax ₹ 54,00,000

(ii) Weighted average number of equity shares outstanding is 1,20,000 shares

(iii) Tax rate 30%

(iv) Option to purchase 20,000 equity shares at ₹ 48 per share. The options were outstanding all year.

(v) Option to purchase 25,000 equity shares at ₹ 18 per share. The average market price of equity share during the year was ₹ 70

(vi) 12% convertible bonds, 500 bonds, each convertible into 10 equity shares. The bonds were outstanding during the entire year. The bonds were issued at par ₹1000 per bond and no bonds were converted during the year.

(vii)8% Convertible cumulative preferred stock per ₹100, 8000 shares issued and outstanding the entire year. Each preferred share is convertible into one equity share. The preferred share was issued at par and no shares were converted during the year. [8]

Answer:

A. Computation of additional Earning per Incremental Share to determine sequence

Particulars	Options-1	Options-2	7% Convertible Bond	Convertible Preference Shares
1. Additional Net Profit after adjusting tax expenses	Nil	Nil	(500 x 1000 x 12%) x 70% = 42,000	(8,000x100x8%) + 30% their on =83,200
2. Additional No. of equity share including for Diluted EPS	20,000x(70-48)/70 = 6,286	25,000x(70-18)/70 = 18,571	500 x 10 = 5,000	8,000 x 1 = 8,000
3. Earning per Incremental share	Nil	Nil	42,000/ 5,000 = 8.40	83,200/ 8,000 = 10.40
B. Priority in Sequence	I	II	III	IV

C. Computation of Diluted EPS in the above sequence

Particulars	Net profit attributable to equity shareholder	Number of Equity Shares outstanding	Earning per share	Nature of potential Equity Share
(1)	(2)	(3)	(4) = (2)/(3)	(5)
1. Net profit for Equity shareholder 2. Add: adjustment for option -1	53,36,000 Nil	1,20,000 6,286	₹44.47	Basic EPS
3. After Option-1 adjustment 4. Add: adjustment for option -2	53,36,000 Nil	1,26,286 18,571	₹42.25	Dilutive

5. After Option-2 adjustment 6. 12% convertible bonds	53,36,000 42,000	1,44,857 5,000	₹36.84	Dilutive
7. After convertible bonds 8. Adjustment for Preference Shares	53,78,000 83,200	1,49,857 8,000	₹35.89	Dilutive
9. After Pref. Share Adjustment	54,61,200	1,57,857	₹34.60	Dilutive

(c) (i) A Fixed asset purchased for ₹20 lakhs, Govt. grant is received ₹8 lakhs (useful life is 4 years, residual value ₹4 lakhs) grant becomes refundable in 3rd year to the extent of ₹6 lakhs. Show accounting under different alternatives assuming SLM method of depreciation. [4]

Answer:

Particulars	Dr. (₹)	Cr. (₹)
(A) Non- Depreciable fixed Asset		
(i) Fixed Asset/ Capital Reserve A/c Dr.	6	
To, Bank A/c		6
(ii) If grant was credited to deferred Govt. grant		
Deference Govt. grant A/c Dr.	4	
Profit and Loss A/c Dr.	2	
To, Bank A/c		6
(Balance left in deferred Govt. grant a/c was ₹4 lakhs because 2 lakhs p.a. was recognised in profit & Loss A/c in last 2 years)		
(B) (i) Depreciable fixed assets – if grant is credited to fixed asset at the time of receipt		
Fixed Asset A/c Dr.	6	
To, Bank A/c		6
(The balance of fixed asset A/c after 2 years depreciation was ₹8 lakhs and now it will become ₹14 lakhs assuming same residual value and remaining life of 2 years ₹5 lakhs depreciation will be charged in remaining 2 years)		
If grant is credited to deferred grant or income at the time of receipt		
(ii) Deferred Govt. Grant A/c Dr.	4	
Profit and Loss A/c Dr.	2	
To bank A/c		6
(Deferred grant account will become will become NIL. The fixed asset will continue to be depreciated at ₹4 lakhs per annum)		

(ii) Discuss the use of the General Purpose Financial Statement. [4]

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

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

3. (Answer any 2 questions)

(a) (i) A limited Company was registered with a capital of ₹ 5,00,000 in share of ₹ 100 each and issued 2,000 such shares at a premium of ₹ 20 per share, payable as ₹ 20 per share on application, ₹ 50 per share on allotment (including premium) and ₹ 20 per share on first call made three months later. All the money payable on application, and allotment were duly received but when the first call was made, one shareholder paid the entire balance on his holding of 30 shares, and another shareholder holding 100 shares failed to pay the first call money.
Required:
Give Journal entries to record the above transactions. [9]

Answer:

Journal

Particulars		L.F.	Dr. Amount ₹	Cr. Amount ₹
Bank A/c	Dr		40,000	
To Share Application A/c				40,000
[Being the issue of 2,000 shares and application money received @ ₹ 20 per share]				
Share Application A/c	Dr		40,000	
To Share Capital A/c				40,000
[Being the transfer of application money on 2,000				
shares @ ₹ 20 per share to Share Capital A/c)				
Share Allotment A/c	Dr		1,00,000	
To Share Capital A/c				60,000
To Securities Premium A/c				40,000
(Being the allotment money on 2,000 shares @ ₹ 50 including premium made due)				

Particulars		L.F.	Dr. Amount ₹	Cr. Amount ₹
Bank A/c	Dr		1,00,000	
To Share Allotment A/c				1,00,000
(Being the allotment money on 2,000 shares				
@ ₹ 50 per share received)				
Share First Call A/c	Dr		40,000	
To Share Capital A/c				40,000
(Being the first call money on 2,000				
shares @ ₹ 20 per share made due)				
Bank A/c	Dr		38,900	
To Share First Call A/c				38,000
To Call-paid-in-advance A/c				900
(Being the first call money on 1,900 shares @ ₹ 20				
per share and share Second call money on 30 shares @ ₹ 30 per share received)				

(ii) A Company has its Share Capital divided into Shares of ₹10 each. On 1st April 2013, it granted 20,000 Employees' Stock Options at ₹ 40, when the Market Price was ₹ 130. The Options were to be exercised between 1st January 2014 to 15th March 2014. The Employees exercised their Options for 18,500 Shares only, the remaining options lapsed. The Company closes its books on 31st March every year. Pass Journal Entries with regard to Employees' Stock Option. [4]

Answer:

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

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

B. Journal Entry for ESOP

Particulars	Dr. (₹)	Cr. (₹)

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

(iii) Discuss the disclosure requirement of debit balance in the Statement of Profit and Loss and in Reserve and Surplus under Revised Schedule VI. [3]

Answer:

Debit balance in the Statement of Profit and Loss which would arise in case of accumulated losses, is to be shown as a negative figure under the head 'Surplus'. The aggregate amount of the balance of 'Reserve and Surplus', is to be shown after adjusting negative balance of surplus, if any. If the net result is negative, the negative figure is to be shown under the head "Reserves and Surplus'.

(b) HHH Ltd. made a public issue of 1,25,000 equity shares of ₹ 100 each, ₹ 50 payable on application. The entire issue was underwritten by four parties—A, B, C and D in the proportion of 30%, 25%, 25% and 20% respectively. Under the terms agreed upon, a commission of 2% was payable on the amounts underwritten.
A, B, C and D had also agreed on "firm" underwriting of 4,000, 6,000, Nil and 15,000 shares respectively.
The total subscriptions, excluding firm underwriting, including marked applications were for 90,000 shares. Marked applications received were as under:

A 24,000	**C 12,000**	**B 20,000**	**D 24,000**

Required: Ascertain the liability of the individual underwriters
Approach I — If benefit of firm underwriting is given to individual underwriters.
Approach II — If the benefit of firm underwriting is not given to individual underwriter. [16]

Answer:

Approach I—If benefit of firm underwriting is given to individual underwriters:

(i) Total Marked applications:

A	B	C	D	Total
24,000	20,000	12,000	24,000	80,000

(ii) Shares subscribed excluding firm underwriting but

including marked applications	90,000 shares

Less: Marked	80,000 shares
Unmarked	10,000 Shares

(iii) Statement Showing the Net and Total Liability of Underwriters

Particulars	A	B	C	D	Total
Gross liability (30:25:25:20)	37,500	31,250	31,250	25,000	1,25,000
Less: Marked applications	(24,000)	(20,000)	(12,000)	(24,000)	(80,000)
Balance	13,500	11,250	19,250	1,000	45,000
Less: Unmarked (In Gross Ratio)	(3,000)	(2,500)	(2,500)	(2,000)	(10,000)
Balance	10,500	8,750	16,750	(1,000)	35,000
Less: Firm Underwriting	(4,000)	(6,000)		(15,000)	(25,000)
Balance	6,500	2,750	16,750	(16,000)	10,000
Surplus of D allocated to A, B & C 30 : 25 : 25	(6,000)	(5,000)	(5,000)	16,000	---
Balance	500	(2,250)	11,750	—	10,000
Surplus of 'B' allocated	(500)	2,250	(1,750)	---	---
Net liability	---	---	10,000	---	10,000
Add: Firm underwriting	4,000	6,000	---	15,000	25,000
Total Liability	4,000	6,000	10,000	15,000	35,000

(iv) Statement showing the Amount due from Underwriters

Particulars	A	B	C	D	Total
Shares to be subscribed	4,000	6,000	10,000	15,000	35,000
Amount due @ ₹ 50 per share (₹)	2,00,000	3,00,000	5,00,000	7,50,000	17,50,000
Less: Commission due @2% on nominal value of share under written (₹)	(75,000)	(62,500)	(62,500)	(50,000)	(2,50,000)
(₹)	1,25,000	2,37,500	4,37,500	7,00,000	15,00,000

Approach II—If the benefit of firm underwriting is not given to individual underwriter

(i) Total marked applications = 80,000

(ii) Share subscribed excluding 'firm' underwriting but

including marked application	90,000	shares
Firm underwriting	25,000	"
Total subscription	1,15,000	"
Less: Marked application	80,000	"
Balance being unmarked	35,000	

(iii) Statement showing the Liability of Underwriters

	Particulars	A	B	C	D	Total
A	Gross liability	37,500	31,250	31,250	25,000	1,25,000
B	Less: Marked applications	(24,000)	(20,000)	(12,000)	(24,000)	(80,000)
C	Less: Unmarked Applications	(3,000)	(2,500)	(2,500)	(2,000)	(10,000)
D	Less: Firm underwriting (in the ratio of 30:25:25:20)	(7,500)	(6,250)	(6,250)	(5,000)	(25,000)
E	Balance	3,000	2,500	10,500	(6,000)	10,000

F	Surplus of D transferred to others in the ratio of 30:25:25	(2,250)	(1,875)	(1,875)	6,000	---
G	Net Liability	750	625	8,625	—	10,000
H	H Add: Firm underwriting	4,000	6,000	Nil	15,000	25,000
I	Total Liability	750	625	8,625	---	10,000
		4,750	6,625	8,625	15,000	35,000

(v) Statement Showing the Amount due from Underwriters

Particulars	A	B	C	D	Total
Shares to be subscribed	4,750	6,625	8,625	15,000	35,000
Amount due @ ₹ 50 shares (₹)	2,37,500	3,31,250	4,31,250	7,50,000	17,50,000
Less: Commission due at 2% on nominal value of shares underwritten (₹)	(75,000)	(62,500)	(62,500)	50,000)	(2,50,000)
(₹)	1,62,500	2,68,750	3,68,750	7,00,000	15,00,000

(vi) Verification:

Taken by public-unmarked application	10,000 shares
Public through underwriters—marked	80,000 shares
By underwriters—under agreement	35,000 shares
	1,25,000 shares

(c) (i) TQM Ltd. group has three divisions T, Q, M. details of their turnover, results and net assets are given below:

	(₹ in lakhs)
Division T	
Sale to Q	**3,050**
Other sales (Home)	**60**
Export sales	**4,090**
	7,200
Division Q	
Sale to M	**30**
Export sales to Europe	**200**
	230
Division M	
Export sales to America	**180**

		Division		
	Head Office	**T**	**Q**	**M**
	(₹ in lakhs)	**(₹ in lakhs)**	**(₹ in lakhs)**	**(₹ in lakhs)**
Operating Profit or loss before tax		**160**	**20**	**(8)**
Re-allocated cost from Head Office		**48**	**24**	**24**
Interest cost		**4**	**5**	**1**
Fixed assets	**50**	**200**	**40**	**120**
Net current assets	**48**	**120**	**40**	**90**
Long-term liabilities	**38**	**20**	**10**	**120**

Prepare a segmental Report for publication in TQM Ltd. Group. **[10]**

Answer:

TQM Ltd.
Segment Report **(₹ in Lakhs)**

	Divisions				
	T	**Q**	**M**	**Inter segment Elimination**	**Consolidated Total**
Segment Revenue Sales:					
Domestic	60	-	-	-	60
Export	4,090	200	180	-	4,470
External Sales	4,150	200	180	-	4,530
Inter-segment sales	3,050	30	-	3,080	-
Total Revenue	7,200	230	180	3,080	4,530
Segment result (given)	160	20	(8)	-	172
Head office expenses					(96)
Operating profit					76
Interest expense					10
Profit before tax					66
Other information					
Fixed Assets	200	40	120	-	360
Net current assets	120	40	90	-	250
Segment Assets	320	80	210	-	610
Unallocated corporate assets					98
Segment Liabilities	20	10	120		150
Unallocated corporate liabilities					38

Sales Revenue by Geographical Market

	Home Sales	Export Sales (by division T)	Export to Europe	Export to America	Consolidated Total
External Sales	60	4,090	200	180	4,530

(ii) The Balance Sheet of A Ltd. as on 31st December was as follows:

EQUITY & LIABILITIES	**₹**
Shareholders' funds	
Share Capital:	
8,000 Preference shares of ₹10 each 80,000	
1,200 Equity shares of ₹10 each 1,20,000	**2,00,000**
Reserves and Surplus – P/L A/c	**(58,000)**
Non- current liabilities	
Bank Loan	**4,00,000**
8% Debentures	**1,00,000**
Current liabilities	
Trade payables	
Sundry Creditors	**2,00,000**

Other current liabilities	
Interest Outstanding on Debentures	**8,000**
Total	**8,50,000**
ASSETS	
Non-current assets	
Fixed Assets	
Land and Building	**25,000**
Other Fixed Assets	**2,00,000**
Current assets	
Inventories — Stock	**5,25,000**
Trade Receivables — Debtors	**1,00,000**
Total	**8,50,000**

The company went into liquidation on that date. Prepare Liquidator's Statement of Account after taking into account the following:

- **Liquidation Expenses and Liquidator's Remuneration amounted to ₹3,000 and ₹10,000 respectively.**
- **Bank Loan was secured by pledge of stock.**
- **Debenture and Interest thereon are secured by a floating charge on all assets.**
- **Fixed assets were realized at book value, and current assets at 80% of book values. [6]**

Answer:

Liquidator's Final Statement of Account

Receipts	₹	Payments	₹
Assets Realized:		Liquidator's Remuneration	10,000
Debtors (1,00,000 x 80%)	80,000	Liquidation Expenses	3,000
Land and Building	25,000	Debentureholders:	
Other Fixed Assets	2,00,000	Debentures having Floating Charge 1,00,000 Interest 8,000	1,08,000
Surplus from Securities:		Unsecured Creditors: Sundry Creditors	2,00,000
Stocks 5,25,000 x 80% 4,20,000		Preference Shareholders (bal fig) at ₹0.50 per share on 8,000 shares	4,000
Less: Bank Loan 4,00,000	20,000		
	3,25,000		3,25,000

4. (Answer any 2 questions)

(a) (i) Difference between Statutory Audit and Government Audit. [6]

Answer:

The following are the differences between Statutory Audit and Government Audit:

SL. No.	Statutory Audit	Government Audit
i.	Applicable to (a) All private companies (b) All co-operative societies (c) Proprietorship and partnership concerns in some cases. E.g. Tax audit under Income Tax Act.	Applicable to (a) Government departments (b) Statutory corporations (c) Government companies
ii.	(a) In case of private companies: shareholders. (b) In case of sole proprietor and partnership: proprietor or partners. (c) In case of trust: trustee or Managing Committee. (d) In case of co-operative societies: Managing Committee with prior approval of the Registrar.	(a) In case of government departments: Comptroller and Auditor General (b) In case of statutory corporation: as per the provisions of the special statute for that corporation. (c) In case of government company: Company Law Board, on the advice of the Comptroller and Auditor General.
iii.	Report is submitted to the owners/ shareholders in a format prescribed by the Companies Act, 1956, in the case of Companies.	Report is submitted to the shareholders and a copy is given to the Comptroller and Auditor General in a format prescribed by the CAG.

(ii) Discuss — Social Audit. **[5]**

Answer:

Social Audit:

Organizations, these days, focus on attaining economic growth through performing processes that ensure social and environmental development simultaneously. A social audit is a way of measuring, understanding, reporting and improving an organization's performance towards meeting its social and ethical objectives.

Objectives of Social Audit

- Assessing the needs of the society and resources available for fulfilling them.
- Spreading awareness among beneficiaries about the business' efforts towards attaining social objectives.
- Increasing efficacy and effectiveness of the organization's corporate social responsibility (CSR) programmes.
- Scrutiny of policy decisions, keeping in view the interests of stakeholders.

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.

(iii) "Auditor's assessment of materiality may be different of the time of planning the engagement than at the time of evaluating the results of his audit procedures", comment. [5]

Answer:

Planning the audit solely to detect individually material misstatements overlooks the fact that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated, and leaves no margin for possible undetected misstatements. Performance materiality (which, as defined, is one or more amounts) is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the financial statements exceeds materiality for the financial statements as a whole. Similarly, performance materiality relating to a materiality level determined for a particular class of transactions, account balance or disclosure is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in that particular class of transactions, account balance or disclosure exceeds the materiality level for that particular class of transactions, account balance or disclosure. The determination of performance materiality is not a simple mechanical calculation and involves the exercise of professional judgment. It is affected by the auditor's understanding of the entity, updated during the performance of the risk assessment procedures; and the nature and extent of misstatements identified in previous audits and thereby the auditor's expectations in relation to misstatements in the current period.

(b) What are the essential features of a good Internal Audit Report? [10]

Answer:

The contents of an Internal Audit Report are based on - (a) nature of internal audit function in the Company, (b) level of reporting, (c) degree of management support, and (d) capabilities of internal audit staff.

A good Internal Audit Report should have the following features -

- Objectivity: In order to maintain the credibility of internal audit function, the comments and opinions expressed in the Report should be as objective and unbiased as possible.
- Clarity: The language used should be simple and straightforward. Use of technical jargon(s) should be avoided. Each draft of the report should be read from the user's viewpoint to confirm clarity.
- Accuracy: The information contained in the report, whether quantified or otherwise, should be accurate. Approximation or assumptions made should be clearly stated along with reasons, if material.
- Conciseness: Brevity is a vital aspect. However, important information should not be omitted.
- Constructiveness: Destructive criticism should be avoided. The report should clearly demonstrate that the Internal Auditor is trying to assist the management in effective discharge of its responsibilities.
- Readability: The reader's interest should be captured and retained throughout. Appropriate paragraph heading may be used.
- Timeliness: The report should be submitted promptly because if the time lag between the occurrence of an event and its reporting is considerable, the opportunity for taking

action may be lost or a wrong decision may be taken in the absence of the information.

- Findings and conclusions: These may be given either department-wise or in the order of importance. All the facts and data pertaining to the situation should be assembled, classified and analysed. Each conclusion and opinion should normally follow the findings. Tables or graphs may be used for the presentation of statistical data in appendices.
- Recommendations: The Internal Audit Report should include recommendations for potential improvements. In order to enable the management to accept and implement the recommendations, the Internal Auditor should be able to convince the management that the conclusions are logical and valid and the recommendations represent effective and feasible ways of taking action.
- Auditee's views: The Auditee's views about audit conclusions or recommendations may also be included in the audit report in appropriate circumstances.
- Summary: A summary of conclusions and recommendations may be given at the end. This is useful in case of lengthy reports.
- Supporting information: The Internal Auditor should supplement his report by such documents and data, which adequately and convincingly support the conclusions. Supporting information may include the relevant standards or regulations.
- Draft Report: Before writing the Final Report, the Internal Auditor should prepare a draft report. This would help him in finding out the most effective manner of presenting his reports. It would also indicate whether there is any superfluous information or a gap in reasoning.

(ii)In XYZ LTD, F a junior accountant was given additional responsibility of making recoveries from the debtors. On one occasion, when an insurance claim of ₹85,000 was received, he credited the same to the account of a debtor and misappropriated the cash which he had recovered from the said debtor. Pinpoint weaknesses in the internal control system which led to this situation. [6]

Answer:

Following two essential features of internal control are relevant here:

(i) Breaking the chain of the work in a manner so that no single person can handle a transaction from the beginning to the end and

(ii) Segregation of accounting and custodial functions.

<u>Weakness in internal control system in the instant case:</u>

i) The accountant is receiving cash and also passing the entries in the books. The accountant should not have been allowed to effect recoveries.

ii) It also appears that system for issuing receipts for amount received - whether cash or cheque is also lacking.

iii) In a small and to some extent medium size organization, the supervision of the owner offsets the deficiencies in internal control system. But in this case, it appears, that supervision and personal control is also lacking.

Thus, in the given case, the main weakness of the system is that it is ignoring the basic requirements of a good internal control system.

(c) (i) Write a note on Annual Audit. [5]

Answer:

Meaning: Annual Audit is conducted at the end of the accounting year, after the books of accounts have been closed.

Procedure

It does not interrupt with the regular functioning of the client's accounting or operations functions and ensures completion of work in one session due to continuity. The auditor may use statistical sampling methods and techniques which lead to time effectiveness. The possibility of tampering with the books of accounts during the audit is considerably reduced as the audit work starts only after the books are closed.

Limitations and precautions

A major disadvantage of annual audit is that all the errors and frauds are found at the end of the accounting year, which makes it very difficult to fix responsibility for defalcations. It delays the presentation of Audited Financial Statements to the shareholders and to prevent the delay, the auditor uses sample testing, which also reduces the possibility of detection of frauds and errors.

(ii) Discuss the types of Internal Control. [8]

Answer:

Types of Internal Control Systems:

The type of internal control system to be employed in an organization depends upon the requirements and nature of the business.

Generally, there are two types of Internal Control in an Organisation:

preventive and detective controls. Both types of controls are essential to an effective internal control system. From a quality standpoint, preventive controls are essential because they are proactive and emphasize quality. However, detective controls play a critical role by providing evidence that the preventive controls are functioning as intended.

Preventive Controls are designed to discourage errors or irregularities from occurring. They are proactive controls that help to ensure departmental objectives are being met.

Examples of preventive controls are:

• **Segregation of Duties:** Duties are segregated among different people to reduce the risk of error or inappropriate action.

• **Approvals, Authorizations, and Verifications:** Management authorizes employees to perform certain activities and to execute certain transactions within limited parameters. In addition, management specifies those activities or transactions that need supervisory approval before they are performed or executed by employees. A supervisor's approval (manual or electronic) implies that he or she has verified and validated that the activity or transaction conforms to established policies and procedures.

Detective Controls are designed to find errors or irregularities after they have occurred.

Examples of detective controls are:

• **Reviews of Performance:** Management compares information about current performance to budgets, forecasts, prior periods, or other benchmarks to measure the extent to which goals and objectives are being achieved and to identify unexpected results or unusual conditions that require follow-up.
• Physical Inventories
• Audits etc.

Corrective Controls target at the correction of errors and irregularities as soon as they are detected.

(iii) Operational audit is merely an extension of Internal Audit, comment. [3]

Answer:

The statement is true. In operational audit function, the internal auditor goes beyond financial controls and looks into operational areas also. Operational auditing having scope and objectives similar to that of Internal Audit is therefore an extent ion of Internal Audit.