Paper – 12: Company Accounts and Audit

The following table lists the learning objectives and the verbs that appear in the syllabus learning aims and examination questions:

	Learning objectives	Verbs used	Definition
LEVEL B	KNOWLEDGE What you are expected to know	List	Make a list of
		State	Express, fully or clearly, the details/facts
		Define	Give the exact meaning of
	COMPREHENSION What you are expected to understand	Describe	Communicate the key features of
		Distinguish	Highlight the differences between
		Explain	Make clear or intelligible/ state the meaning or purpose of
		Identity	Recognize, establish or select after consideration
		Illustrate	Use an example to describe or explain something
	APPLICATION How you are expected to apply your knowledge	Apply	Put to practical use
		Calculate	Ascertain or reckon mathematically
		Demonstrate	Prove with certainty or exhibit by practical means
		Prepare	Make or get ready for use
		Reconcile	Make or prove consistent/ compatible
		Solve	Find an answer to
		Tabulate	Arrange in a table
	ANALYSIS How you are expected to analyse the detail of what you have learned	Analyse	Examine in detail the structure of
		Categorise	Place into a defined class or division
		Compare and contrast	Show the similarities and/or differences between
		Construct	Build up or compile
		Prioritise	Place in order of priority or sequence for action
		Produce	Create or bring into existence

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) R Ltd. furnished the following particulars on 01.01.2011, from which you are asked to ascertain the basic EPS:

R Ltd. issued 2,00,000 equity shares of ₹ 10 each, fully paid ₹ 20,00,000. Issue of right share among existing shareholders: one for one of ₹ 25 each on 1.7.2012.On 31.12.2011 the basic reported EPS was ₹ 2.50 and market price of the share prior to right issue was ₹ 40. Net Profit (After Tax) for 2011 ₹ 2,50,000 for 2012 ₹ 3,00,000.

Answer:

$$= \frac{\text{Fair value of all outstanding shares immediately prior to exercise of right} + \text{Total amount received fromexerviseofrights}}{\text{No. of shares outstanding prior to excise of right} + \text{No. of shares issued in the exercise}}$$

$$\frac{(2,00,000 \times ₹40) + (2,00,000 \times ₹40)}{20,000 + 20,000}$$

$$= \frac{₹80,000 + ₹50,00,000)}{40,000} = ₹\ 32.50$$

Adjustment Factor

$$= \frac{\text{Fair value per share immediately prior to exercise of rights}}{\text{Theoretical Ex - right fair value per share}}$$

$$= \frac{₹40.00}{₹32.50}$$

= 1.23

(d) Foreign currency creditors at the end of the financial year are USD 10 Lakhs. Purchase were recorded at the exchange rate USD 1= ₹52. On the balance sheet date, the exchange rate is USD 1 = ₹54 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 - ₹55.00 to ₹56.50. 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 = (₹55.00 + ₹56.50) ÷ 2 = ₹55.75 per USD. The amount of creditors recognized in the B/S shall be ₹55.75 x 10 Lakhs USD = ₹557.50 Lakhs.

Treatment of foreign exchange loss –

The Exchange Loss of (₹55.75 – ₹52) 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.	3,00,000	
Securities Premium A/c	Dr.	40,000	
General Reserve A/c	Dr.	20,000	
To, Equity Shareholders A/c			3,60,000
(Being the amount due to equity shareholders for buying-back of 30,000 equity shares)			
General Reserve A/c	Dr.	3,00,000	
To, Capital Redemption Reserve A/c			
(Being the nominal amount or equity shares bought back			3,00,000

transferred)		

(f) Journalise the following transaction:

FD Ltd. issued 24,000 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.		24,00,000	
To, Share Capital A/c			24,00,000
[Being the issue of 24,000 shares of ₹100 each at par to promoters as per Board's Resolution dated…..]			

(g) List the uses of Interim Audit.

Answer:

Following are the use of Interim Audit:

- Early detection and rectification of errors & frauds
- Publishing of interim results in some cases
- Timely completion of records and final audit
- Moral checks on employees

(h) 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.

(i) As per section 139 of Companies Act, 2013 an auditor shall furnish a certificate and consent — discuss.

Answer:

As per section 139(8) before any appointment of auditor, the auditor shall furnish to the company —

(a) His written concent for such appointment; and
(b) A certificate that —
- The appointment, if made, shall be in accordance with the conditions as may be prescribed; and
- The auditor satisfies the criteria provided in section 141.

(j) State what is Efficiency Audit?

Answer:

Efficiency Audit ensures the economical execution of various schemes and policies. It refers to the relationship between inputs and output i.e. the goods and services produced and resources used to produce them, yielding the expected results.

2. (Answer any 2 questions)

(a) H Ltd. sold machinery having WDV of ₹ 400 Lakhs to B Ltd. for ₹ 500 Lakhs and the same machinery was leased back by B Ltd. to H Ltd. The Lease back is operating lease. [8]

Comment if –

(i) Sale price of ₹ 500 lakhs is equal to fair value
(ii) Fair value is ₹ 600 lakhs
(iii) Fair value is ₹ 450 lakhs and sale price is ₹ 380 lakhs
(iv) Fair value is ₹ 400 lakhs and sale price is ₹ 500 lakhs
(v) Fair value is ₹ 460 lakhs and sale price is ₹ 500 lakhs
(vi) Fair value is ₹ 350 lakhs and sale price is ₹ 390 lakhs

Answer:

(i) H ltd. should immediately recognize the profit of ₹ 100 lakhs in its books.

(ii) Profit ₹ 100 lakhs should be immediately recognized by H Ltd.

(iii) Loss of ₹ 20 lakhs to be immediately recognized by H Ltd. in its books provided loss is not compensated by future lease payment.

(iv) Profit of ₹ 100 lakhs is to be amortized over the lease period.

(v) Profit of ₹ 60 lakhs (460-400) to be immediately recognized in its books and balance profit of ₹ 40 lakhs (500-460) is to be amortized / deferred over lease period.

(vi) Loss of ₹ 50 lakhs (400-350) to be immediately recognized by H Ltd. in its books and profit of ₹ 40 lakhs (390-350) should be amortized / deferred over lease period.

(b) (i) An Enterprise discontinues a business segment and employees of the discontinued segment will earn no further benefits. This is a curtailment without a settlement. Using current actuarial assumptions (including current market interest rates and other current market prices) immediately before the curtailment, the enterprise has a Defined Benefit Obligation with a Net Present Value of ₹1,000 and Plan Assets with a Fair Value of ₹820 and unrecognised Past Service Cost of ₹ 50. The Enterprise had first adopted this statement one year before. This increased the Net Liability by ₹100, which the Enterprise chose to recognize over five years. The curtailment reduces the Net Present Value of the obligation by ₹ 100, to ₹ 900. How will the Enterprise recognize this curtailment under AS -15. [6]

Answer:

Of the previously unrecognised Past Service Cost and transitional amounts, 10% (₹ 100 out of ₹ 1,000) relates to the part of the obligation that was eliminated through the curtailment. So, the effect of the curtailment is as follows -

(Amout in ₹)

Particulars	**Before Curtailment**	**Curtailment Gain**	**After Curtailment**
Net Present Value of Obligation	1,000	(100)	900
Less: Fair Value of Plan Assets	820	-	820
Balance	180	(100)	80
Less: Unrecognised Past Service Cost	(50)	5	(45)
Less: Unrecognised transitional amount	(100 × 4 / 5) (80)	8	(72)
Net Liability recognized in the B/S	50	(87)	(37)

Therefore, an Asset of ₹37 will be recognized. (It is assumed that the amount under para 59(b) is higher than ₹37).

(ii) Define Government Grants. **[2]**

Answer:

Government Grants are assistance by Government, in cash or kind to an enterprise, for past or future compliance with certain conditions. They exclude (a) those forms of Government assistance which cannot reasonably have a value placed upon them, and (b) transactions with Government which cannot be distinguished from the trading transactions of the enterprise.

(c) (i) Discuss the use of the General Purpose Financial Statement. **[4]**

Answer:

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

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

(ii) Explain the accounting treatment of Internally Generated Goodwill. **[4]**

Answer:

- **Expenditure incurred**: Expenditure incurred to generate future economic benefits, need not necessarily result in creation an Intangible Asset that meet the recognition criteria.

Such expenditure is described as contributing to Internally Generated Goodwill.

- **Recognition Criteria not satisfied**: Internally Generated Goodwill is not an identifiable resource controlled by the Enterprise that can be measured reliably at cost.
- **Conclusion**: Hence, Internally Generated Goodwill should not be recognized as an asset.
- **Market Capitalisation:** Differences between the market value of an Enterprise and the carrying amount of its identifiable net assets at any point in time may be due to a range of factors that affect the Enterprise value. However, such differences cannot be considered to represent the cost of Intangible Assets controlled by the Enterprise.
- Example: Ranjani Ltd's Tangible Net Worth as per the latest Balance Sheet is ₹ 400 Crores. The Company has a Capital of 2 Crores Equity Shares of ₹ 200 each, but quoted at ₹ 280 per Share on the date of the Balance Sheet. The Market Value of the Firm is (₹ 280 × 2 Crore Shares = ₹ 560 Crores. The difference of ₹160 Crores between its Market Value ₹ 560 Crores and Tangible Book Net Worth ₹ 400 Crores should not be recognized as an Intangible Asset.

3. (Answer any 2 questions)

(a) (i) Q Ltd. grants 1,000 options to its employees on 01.04.2011 at ₹60. The vesting period is two and a half years. The maximum period is one year. Market price on that date is ₹90. All the options were exercised on 31.07.2014. Journalize, if the face value of equity share is ₹10 per share. [9]

Answer:

Date	Particulars	Dr.(₹)	Cr.(₹)
31.03.12	Employees Compensation Expense A/c Dr. To Employees Stock Option Outstanding A/c (Being compensation expense recognized in respect of 1,000 options granted to employees at discount of ₹ 30 each, amortized on straight line basis over 2 ½ years)	12,000	12,000
	Profit and Loss A/c Dr. To Employees Compensation Expense A/c (Being employees compensation expense of the year transferred to P&L A/c)	12,000	12,000
31.03.13	Employees Compensation Expense A/c Dr. To Employees Stock Option Outstanding A/c (Being compensation expense recognized in respect of 1,000 options granted to employees at discount of ₹ 30 each, amortized on straight line basis over 2 ½ years)	12,000	12,000
	Profit and Loss A/c Dr. To Employees Compensation Expense Account (Being employees compensation expense of the year transferred to P&L A/c)	12,000	12,000

31.03.14	Employees Compensation Expense A/c Dr. To Employees Stock Option Outstanding A/c (Being balance of compensation expense amortized ₹ 30,000 less ₹ 24,000)	6,000	 6,000
	Profit and Loss A/c Dr. To Employees Compensation Expense A/c (Being employees compensation expense of the year transferred to P&L A/c)	6,000	 6,000
31.07.14	Bank A/c (₹60 × 1,000) Dr. Employees Stock Option outstanding A/c (₹30 × 1,000) Dr. To Equity Share Capital A/c To Securities Premium A/c (Being exercise of 1,000 option at an exercise price of ₹60 each and an accounting value of ₹30 each)	60,000 30,000	 10,000 80,000

Working Notes:

(i) Total Employees Compensation Expense m 1,000 × (₹ 90 - ₹ 60) = ₹ 30,000
(ii) Employees Compensation Expense has been written off during 2 ½ years on straight line basis as under:
I year = ₹12,000 (for full year)
II year = ₹ 12,000 (for full year)
III year = ₹ 6,000 (for half year)

(ii) Discuss the disclosure requirement of debit balance in the Statement of Profit and Loss and in Reserve and Surplus under Revised Schedule III. [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'.

(iii) Discuss "Cash and Cash Equivalents". [4]

Answer:

Cash means cash in hand and balance of foreign currency.

Cash equivalent implies bank balance and other risk-free short term investments, and advances which are readily encashable.

Cash equivalent 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. An investment of short maturity, say three months or less from the date of acquisition is generally considered as cash equivalent. Equity investments are not considered as cash equivalent because of high market risk. Investments in call money market, money market mutual funds, repo transactions etc., are usually classified as cash equivalents.

(b) (i) M Ltd. has the following business/geographical segments.

Examine which of these are reportable Segments under AS - 17.

(Information in ₹000's)

Segments	Revenue	Profit/ (Loss)	Assets
A	9,600	1,750	4,100
B	300	180	450
C	100	70	450

[8]

Answer:

Particulars (₹ in Lakhs)	A	B	C	Total
1. Segment Revenue	9,600	300	100	10,000
2. Percentage of Segment Revenue	96%	3%	1%	100%
3. Segment Result i.e. Profit	1,750	180	70	2,000
4. Percentage of Segment Result, absolute amount of Profit or Loss, whichever is higher i.e. percentage of 2,000	87.5%	9%	3.5%	100%
5. Segment Assets	4,100	450	450	5,000
6. Percentage of Segment Assets	82%	9%	9%	100%
7. Reportable Segment	Yes	No	No	
8. Criteria satisfied	All	Nil	Nil	

A. Single Segment Principle: Disclosure of Segment Information as per AS - 17 is not required, if there is not more than one business / geographical segment. This is because, the relevant information is available from the Balance Sheet and Profit & Loss Account itself.

B. Analysis and Conclusion: Since Segments B and C do not meet the reportable segment criteria and also] 75% condition is satisfied by Segment A alone, only Segment A is identified as a Reportable Segment.

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

EQUITY & LIABILITIES		₹
Shareholders' funds		
Share Capital:		
16,000 Preference shares of ₹10 each	1,60,000	
24,000 Equity shares of ₹10 each	2,40,000	4,00,000
Reserves and Surplus – P/L A/c		(1,16,000)
Non- current liabilities		
Bank Loan		8,00,000
8% Debentures		2,00,000
Current liabilities		
Trade payables		
Sundry Creditors		4,00,000

Other current liabilities	
Interest Outstanding on Debentures	**16,000**
Total	**17,00,000**
ASSETS	
Non-current assets	
Fixed Assets	
Land and Building	**50,000**
Other Fixed Assets	**4,00,000**
Current assets	
Inventories — Stock	**10,50,000**
Trade Receivables — Debtors	**2,00,000**
Total	**17,00,000**

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 ₹6,000 and ₹20,000 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	40,000
Debtors (2,00,000 x 80%)	1,60,000	Liquidation Expenses	12,000
Land and Building	50,000	Debentureholders:	
Other Fixed Assets	4,00,000	Debentures having Floating Charge 4,00,000 Interest 32,000	4,32,000
Surplus from Securities:		Unsecured Creditors: Sundry Creditors	8,00,000
Stocks 10,50,000 x 80% 8,40,000		Preference Shareholders (bal fig) at ₹0.50 per share on 16,000 shares	8,000
Less: Bank Loan 8,00,000	40,000		
	6,50,000		6,50,000

(iii) On April 1, 2014 PT Ltd. issued 25,00,000 12% fully convertible debentures of ₹ 100 each at par. The debenture holders were given the call option to convert the debentures into ₹ 10 equity shares at a premium of ₹ 40 per share on or after July 1, 2018. On April 1, 2019, debenture holders

holding 10,00,000 debentures exercised their option. Pass the necessary journal entries. [2]

Answer:

Date	Particulars	Dr. (₹ in lakhs)	Cr. (₹ in lakhs)
01.04.2014	Bank A/c Dr. To 12% Convertible Debentures A/c (Issue of 25,00,000 convertible debentures of ₹100 each)	2,500	 2,500
	12% Convertible Debentures A/c Dr. To Equity Share Capital A/c To Security Premium A/c Dr. (Conversion of 10,00,000 debenture each, into equity shares of ₹10 at a premium of ₹40 each)	1,000	 1,000

(c) M & N have been carrying on same business independently. Due to competition in the market, they decided to amalgamate and form a new company called MN Ltd. following is the Balance Sheet of M & N as at 31st march:

(in ₹)

Liabilities	M	N	Assets	M	N
Capital	7,75,000	8,85,000	Plant & Machinery	4,85,000	6,14,000
Current liabilities	6,23,500	5,57,600	Building	7,50,000	6,40,000
			Current Assets	1,63,500	1,58,600
	13,98,500	14,12,600		13,98,500	14,12,600

Following are the additional information:

(i) Liabilities of M include ₹ 50,000 due to N for purchases made. N made a profit of 20% on sale to M.

(ii) M has goods purchased from N, cost to N being ₹ 10,000. This is included in the Current Assets of M as on 31st March.

(iii) The assets of M and N are revalued as under:

Particulars	M	N
Plant & Machinery	5,25,000	6,75,000
Building	7,75,000	6,48,000

(iv) The Purchase Consideration is to be discharged as under:

- **Issue 24,000 Equity Shares of ₹ 25 each fully paid, up in proportion of the profitability in the preceding 2 years, which are given below:**

Particulars	M	N
1st Year	2,62,800	2,75,125
2nd Year	2,12,200	2,49,875
Total	4,75,000	5,25,000

- **Issue 12% Preference Shares of ₹ 10 each at per, to provide Income equivalent to 8% Return on Capital Employed in the business as on 31st March, after revaluation of assets of M & N respectively.**

You are required to:

A. Compute the amount of Equity and Preference Shares issued to M & N.

B. Prepare the Balance Sheet of MN Ltd immediately after amalgamation. [16]

Answer:

Computation of Shares issuable to M & N

	Particulars	M	N
	Plant and Machinery	5,25,000	6,75,000
	Building	7,75,000	6,48,000
	Current Assets	1,63,500	1,58,600
	Total of above	14,63,500	14,81,600
	Less: Current Liabilities	(6,23,500)	(5,57,600)
(a)	Net Assets Taken over = Capital Employed	8,40,000	9,24,000
(b)	8% Return on Capital Employed	67,200	73,920
(c)	Valued of Preference Capital to earn above Income =(b) ÷12%	5,60,000	6,16,000
(d)	Preference Shares to be issued = (c) ÷ ₹ 10	56,000 Shares	61,600 Shares
(e)	No. of Equity Shares to be issued (Given 24,000 Shares in Ration of 475 : 525)	11,400 Shares	12,600 Shares
(f)	Value of Equity Share Capital = (e) × ₹ 25	2,85,000	3,15,000
(g)	Total Purchase Consideration = (c) + (f)	8,45,000	9,31,000
(h)	Goodwill = (g) - (a)	5,000	7,000

Computation of Current Assets for B/s purposes

Particulars	M	N
Balances before amalgamation	1,63,500	1,58,600
Less: Liabilities of M due to N	---	(50,000)
Less: Unrealised Profit on Stock, i.e., ₹ 10,000 × 20%, adjusted/added to Goodwill	(2,000)	---
Total	1,61,500	1,08,600

Balance Sheet of MN Ltd as at 31st march (after Takeover)

	Particulars as at 31st March	Note	This Yr.	Prev. Yr.
I	Equity and Liabilities:			
(1)	Shareholders' Funds : Share Capital	1	17,76,000	
(2)	Current Liabilities (6,23,500 + 5,57,600 – Mutual Owings 50,000)		11,31,100	
	Total		29,07,100	
II	Assets			
(1)	Non-Current Assets			
	Fixed Assets: (i) Tangible Assets	2	26,23,000	
	(ii) Intangible Assets Goodwill (5,000 + 7,000 + 2,000)		14,000	

(2)	Current Assets (WN 2) (1,61,500 + 1,08,600)		2,70,100	
	Total		29,07,100	

Note: Since Assets are revalued and Goodwill is accounted for, the Assets and Liabilities are not taken over at their Currying Amounts. Hence, Purchase Method of accounting is followed here.

Note 1: Share Capital

Particulars	This Yr.	Prev. Yr.
Authorised: ……………. Equity Shares of ₹ ……….. each	25,00,000	
………… 12% Preference Shares of ₹ 10 each		
Issued, Subscribed & Paid Up 24,000 Equity Shares of ₹ 25 each	6,00,000	
1,17,600 12% Preference Shares of ₹ 10 each	11,76,000	
(All the above Equity and Preference Shares issued for non-cash consideration)		
Total	17,76,000	

Note 2: Tangible Fixed Assets

Particulars	This Yr.	Prev. Yr.
(a) Building (7,75,000 + 6,48,000)	14,23,000	
(b) Plant & Machinery (5,25,000 + 6,75,000)	12,00,000	
Total	26,23,000	

4. (Answer any 2 questions)

(a) (i) What factors should be considered while analytical procedures are performed as substantive procedures? [6]

Answer:

This Standard on Auditing (SA) deals with the auditor's use of analytical procedures as substantive procedures ("substantive analytical procedures"). The use of analytical procedures as risk assessment procedures is dealt with in SA 315. SA 330 includes requirements and guidance regarding the nature, timing and extent of audit procedures in response to assessed risks; these audit procedures may include substantive analytical procedures.

The auditor's substantive procedures at the assertion level may be tests of details, substantive analytical procedures, or a combination of both. The decision about which audit procedures to perform, including whether to use substantive analytical procedures, is based on the auditor's judgment about the expected effectiveness and efficiency of the available audit procedures to reduce audit risk at the assertion level to an acceptably low level.

The auditor may inquire of management as to the availability and reliability of information needed to apply substantive analytical procedures, and the results of any such analytical procedures performed by the entity. It may be effective to use analytical data prepared by management, provided the auditor is satisfied that such data is properly prepared.

(ii) 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.

(b) (i) List the services that an auditor shall not render as per section 144 of the Companies Act,2013. [8]

Answer:

An auditor appointed under this Act shall provide to the company only such other services as are approved by the Board of Directors or the audit committee, as the case maybe, but which shall not include any of the following services (whether such services are rendered directly or indirectly to the company or its holding company or subsidiary company) namely:

- accounting and book keeping services;
- internal audit;
- design and implementation of any financial information system;
- actuarial services;
- investment advisory services;
- investment banking services;
- rendering of outsourced financial services;
- management services; and
- other kind of services as may be prescribed.

Provided that an auditor or audit firm who or which has been performing any non-audit services on or before the commencement of this Act shall comply with the provisions of this section before the closure of the first financial year after the date of such commencement.

Explanation —

For the purposes of this sub-section, the term "directly or indirectly" shall include rendering of services by the auditor,—
(i) in case of auditor being an individual, either himself or through his relative or any other person connected or associated with such individual or through any other entity, whatsoever, in which such individual has significant influence or control, or whose name or trade mark or brand is used by such individual;
(ii) in case of auditor being a firm, either itself or through any of its partners or through its parent, subsidiary or associate entity or through any other entity, whatsoever, in which the firm or any partner of the firm has significant influence or control, or whose name or trade mark or brand is used by the firm or any of its partners.

(ii) Discuss the procedure of redemption of debentures and the duties of an auditor in relation to redemption of debentures. [5]

Answer:

Redemption of Debentures:

A company may issue debentures with an option to convert such debentures into shares, either wholly or partly at the time of redemption. If debentures are redeemable it can be redeemed in any of the following way:
(i) By way of periodical drawing i.e. by creating Debenture Redemption Reserve Account.
(ii) By way of payment on fixed date.
(iii) By payment whenever the company desires to do so.

Auditor's Duty:

- The auditor should inspect the debentures or trust deed for the terms and conditions regarding redemption of debentures.
- He should see the Director's minute book authorizing the redemption of debentures.
- He should also vouch the redemption with the help of debenture bonds cancelled and the cash book.
- He should also examine the accounting treatment thoroughly.

(iii) State what is internal Control Questionnaire? [3]

Answer:

Internal Control Questionnaire is the most widely used method for collecting information regarding the internal control system and involves asking questions to various people at different levels in the organization. The questionnaire is in a pre-designed format to ensure collection of complete and all relevant information. The questions are formed in a manner that would facilitate obtaining full information through answers in "Yes" or "No''.

(c) (i) 'The type of internal control system to be employed in an organization depends upon the requirements and nature of the business.' Discuss the different types of Internal Controls. [6]

Answer:

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. Normally, responsibilities for authorizing transactions (approval), recording transactions (accounting) and handling the related asset (custody) are divided.

There are also other examples of preventive controls — Approvals, Authorizations, and Verifications, Security of Assets (Preventive and Detective) etc.

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.

There are also other examples of detective controls — Reconciliations, Physical Inventories, Audits, etc.

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

(ii) Discuss cut off procedure. Explain its significance in the context of Auditing. [4]

Answer:

Cut off procedure would mean a procedure adopted to give a delink between two time periods prompted by accounting procedure or a legal requirement.

Example: Date of accounting closing to ascertain the profit or loss - for accounting procedure. Ascertain the profits between pre and post incorporation periods - legal requirement.

Possible areas where cut off procedure has significant impact is given below:

- Accounts receivable and accounts payable these are the most susceptible to recording of transactions in the inappropriate accounting period.
- Purchase bills or rising of sales invoice which requires to be linked to the accounting period for determining the profit or loss of the period.

It is the auditor's duty to examine cut off points and ensure that the transactions are recorded in the relevant period in which the commercial transactions relate to or take place.

(iii) Verify the procedure of allowing Retirement Gratuity to Employees. [6]

Answer:

Procedure of allowing Retirement Gratuity to Employees:

i. Check the basis on which the gratuity payable to employees is worked out. The liability for gratuity may either be worked out on actuarial rules or agreement or on the presumption that all employees retire on the balance sheet date.
ii. Ensure that the basis of computing gratuity is valid.
iii. Verify computation of liability of gratuity on the aggregate basis.
iv. Check the amount of gratuity paid to employees who retired during the year with reference to number of years of service rendered by them.
v. See that the annual premium has been charged to Profit and Loss Account in case the concern has taken a policy from LIC.
vi. Ensure that the accounting treatment is in accordance with AS-15.