Paper 12 – Company Accounts & Audit

Whenever necessary suitable assumptions may be made and disclosed by way of note.

Working Notes should form part of the answers

Section A

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

(i) A hydro-electricity generation company holds non-inter changeable machine spares which are not capitalised to the plant and machinery and carried as inventories. Average holding period of such inventories is around 2 years. It has normal collection period of trade receivables 2 months. Should the company take 2 years 2 months as its operating cycle? [2]

Solution:

The company should exclude inventories of spares from its operating cycle measurement. Spares are inventories but do not form part of operating cycle as they are not direct input or output or semi-processed output.

(ii) An entity has granted mobilisation advance to the contractors amounting to ₹20 lacs. How should the entity classify this advance as current and non-current? [2]

Solution:

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.

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

(a) X Ltd. received a loan from government amounting to ₹20 lacs at a subsidised rate of 4% on 1.4.2009 to be repaid over 5 years on annual equated instalment basis. The benchmark yield for the loan is 10%.

(i) How is the company making payment to the loan?
(ii) What is the fair value of loan as on 1.4.2009?
(iii) Is there any government grant?
(iv) How shall the company account for the loan and government grant component, if any?
(v) Show the loan accounting schedule and recognition of grant as income. [8]

Solution:
(i) Schedule showing repayment of loan: *(Amount in ₹)*

Year	DF@4%	Instalment	Interest	Principal repayment	Remaining Principal
0	1				20,00,000.00
1	0.961538	4,49,254.26	80,000.00	3,69,254.26	16,30,745.74
2	0.924556	4,49,254.26	65,229.83	3,84,024.43	12,46,721.31
3	0.888996	4,49,254.26	49,868.85	3,99,385.41	8,47,335.90
4	0.854804	4,49,254.26	33,893.44	4,15,360.82	4,31,975.08
5	0.821927	4,49,254.26	17,279.18	4,31,975.08	0.00
	4.451822				

Annual equated payment = ₹ 20,00,000.00/4.451822 = ₹ 4,49,254.26

(ii) Fair value of the loan is present value of future cash flows discounted applying benchmark yield: *(Amount in ₹)*

Year	DF@ 10%	Cash Flow	Discounted Cash Flow
0	1		
1	0.909091	4,49,254.26	4,08,413.00
2	0.826446	4,49,254.26	3,71,284.39
3	0.751315	4,49,254.26	3,37,531.46
4	0.683013	4,49,254.26	3,06,846.50
5	0.620921	4,49,254.26	2,78,951.40
			17,03,026.75

(iii) Amount of government grant: ₹ 20,00,000.00 - ₹ 17,03,026.75 = ₹ 2,96,973.25.

(iv) Journal Entry at Initial recognition:

Bank	Dr.	₹ 20,00,000.00	
To Loan			₹ 17,03,026.75
To Grant Reserve			₹ 2,96,973.25

Grant reserve is deferred income. It is recognised over the tenure of the loan. The entity would recognise income in the ratio of amortised cost of the loan at the beginning of year.

(v) Loan Accounting schedule and recognition of income out of grant reserve:

(Amount in ₹)

Year	*Instalment*	*Interest @ 10% p.a.*	*Principal repayment*	*Remaining Principal Balance*	*Income recognition*	*Balance of Grant Reserve*
0				17,03,026.75		2,96,973.25
1	4,49,254.26	1,70,302.68	2,78,951.58	14,24,075.17	93,098.66	2,03,874.59
2	4,49,254.26	1,42,407.52	3,06,846.74	11,17,228.43	77,849.33	1,26,025.26
3	4,49,254.26	1,11,722.84	3,37,531.42	7,79,697.01	61,075.06	64,950.20
4	4,49,254.26	77,969.70	3,71,284.56	4,08,412.45	42,623.37	22,326.83
5	4,49,254.26	40,841.81	4,08,412.45	0.00	22,326.83	0.00
			17,03,026.75		**2,96,973.25**	

In fact there is a debate on deferral of grant recognition in the statement of income. Deferred grant is presented as a liability without having a liability.

(b)(i) Samik Ltd. discontinues a business segment. Under the agreement with employee's union, the employees of the discontinued segment will earn no further benefit. This is a curtailment without settlement, because employees will continue to receive benefits for services rendered before discontinuance of the business segment. Curtailment reduces the gross obligation for various reasons including change in actuarial assumptions made before curtailment. In this, if the benefits re determined based on the last pay drawn by employees, the gross obligation reduces after the curtailment because the last pay earlier assumed is no longer valid.

Assuming the following:

a) **Immediately before the curtailment, based on current actuarial assumption, the gross obligation was estimated at ₹2,000 lakhs**
b) **The fair value of plan assets on the date was estimated at ₹1,700 lakhs**
c) **The unamortized past service cost was ₹60 lakhs**
d) **Curtailment reduces the obligation by ₹200 lakhs, which is 10% of the gross obligation.**

Samik Ltd. estimates the share of unamortized service cost that relates to the part of the obligation that is eliminated at 10% of ₹60 lakhs or at ₹6 lakhs. Calculate the gain form curtailment. [4]

Solution:

Gain from curtailment is estimated as under	
Reduction in gross obligation	₹ 200 lakhs
Less: Proportion on unamortised past service cost	6 lakhs
Gain from curtailment	**₹ 194 lakhs**

The liability to be recognised after curtailment in the balance sheet is estimated as under	
Reduced gross obligation	₹1,800 lakhs
Less: Fair value of plan assets	1,700 lakhs
	100 lakhs
Less: Unamortised past service cost	54 lakhs
Liability to be recognised in the balance sheet	₹46 lakhs

(ii) M Ltd took a factory premises on lease on 01.04.2010 for ₹2,00,000 per month. The lease is operating lease. During March 2011, M Ltd relocates its operation to a new factory building. The lease on the old factory premises continues to be live upto 31.12.2013. The Lease cannot

be cancelled and cannot be sub-let to another user. The auditor insists that lease rent of balance 33 months upto 31.12.2013 should be provided in the accounts for the year ending 31.3.2011. M Ltd seeks your advice. [4]

Solution:

"Onerous Contract" is a contract in which the unavoidable costs of meeting the obligation under the Contract exceeds 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 next 33 months up to 31.12.2013 will be Nil.

However, the Lessee, M Ltd has to pay lease rent of ₹66,00,000 (i.e. 2,00,000 p.m. for next 33 months). Therefore, provision on account of ₹66,00,000 is to be made in the accounts for the year ending 31.03.2011, in accordance with AS - 29 requirements.

(c)(i) 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]

Solution:

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.

(ii) Can an enterprise capitalise advertisement for brand building? Is it possible to capitalise advertisement costs in the form of sponsorship of an event which is material? [4]

Solution:

It will difficult to segregate advertisement costs incurred for brand building from general marketing expense for product promotion.

Moreover, the periods during which the future economic benefits probably would be received and the amounts of such benefits could not be measured and determined easily and objectively.

Even if the sponsorship of an event requires incurrence of material costs, it is in general an advertising expense. The following are the reasons that costs incurred in anticipation of the probable future economic benefits of advertising generally are expensed:

a. It is generally presumed that the benefits period is short.
b. The periods during which the future economic benefits probably would be received and the amounts of such benefits could not be measured and determined easily and objectively.
c. On materiality reason the advertising costs cannot be capitalized.

Section B

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

(i) A company presents supplementary consolidated financial statements in the same annual report along with the separate financial statements. Should the company present segment information for the separate financial statements as well as consolidated a financial statements? [2]

Solution:

In the given case, the segment disclosures as per AS 17 is presented in the context of consolidated financial statements only.

(ii) A software firm develops customised software and therefore development time varies depending upon the nature of individual work. It bills customers when milestone is achieved as per the contract. Customers on an average pay within 60 days of billing.

Should it take into account work-in-progress time while computing operating cycle? [2]

Solution:

Yes. It should take into account weighted average development time of various projects plus the collection period. It may exclude the development time of an individual project which is of special nature and time frame of which is completely different.

(iii) An entity has suffered a loss on stand-alone financial futures. The futures were purchased for ₹5,40,000 and its mark to market value as on the reporting date is ₹ 4,40,000.

How should the entity classify its obligation under futures? [2]

Solution:

Stand-alone derivatives are classified as held for trading financial assets or financial liabilities. In the given case derivative having negative value is a financial liability and classified as held for trading liability. So it is classified as an item of current liability.

(iv) A company purchases inventory for US$ 10,000 when spot US$ 1 = 46.20 and settled the creditors when spot US$ 1= 45.80. How should the operating cash flow be calculated? [2]

Solution:

Direct Method:	Purchases (Initially recorded)	₹ 4,62,000
	Minus Exchange Gain	₹ 4,000
	Cash paid	₹ 4,58,000

Indirect Method: PBIT is already adjusted for the gain.

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

(a) The Authorised Capital of Jagadguru Ltd is ₹5,00,000 consisting of 2,000 6% Preference Shares of ₹100 each and 30,000 Equity Shares of ₹10 each. The following was the Trial Balance of the Company as on 31st March, 2014: (₹)

Particulars	Dr.	Cr.
Investment in Shares at Cost	50,000	
Purchases	5,90,500	
Selling Expenses	79,100	
Stock as at the beginning of the year	1,45,200	
Salaries and Wages	52,000	
Cash on Hand	12,000	
Interim Preference Dividend for the half year to 30th September	6,000	
Discount on Issue of Debentures	2,000	
Preliminary Expenses	1,000	
Bills Receivable	41,500	
Interest on Bank Overdraft	7,800	
Interest on Debentures upto 30th September (1st Half Year)	3,750	
Sundry Debtors and Creditors	50,100	87,850
Freehold Property at Cost	3,50,000	
Furniture at Cost Less Depreciation of ₹15,000	35,000	
6% Preference Share Capital		2,00,000
Equity Share Capital fully paid up		2,00,000
5% Mortgage Debentures secured on Freehold Properties		1,50,000
Income Tax paid in advance for the current year	10,000	
Dividends		4,250
Profit and Loss A/c (Opening Balance)		28,500
Sales (Net)		7,70,350
Bank Overdraft secured by hypothecation of Stocks and Receivables		1,50,000
Technical Knowhow Fees at cost paid during the year	1,50,000	
Audit Fees	5,000	
Total	15,90,950	15,90,950

You are required to prepare the Profit and Loss A/c for the year ended 31st March and the Balance Sheet as on that date after taking into account the following -

1. **Closing Stock was valued at ₹ 1,42,500.**
2. **Purchases include ₹ 5,000 worth of goods and articles distributed among valued customers.**
3. **Salaries and Wages include ₹ 2000 being Wages incurred for installation of Electrical Fittings which were recorded under "Furniture".**

4. **Bills Receivable include ₹ 1,500 being dishonoured bills. 50% of which had been considered irrecoverable.**
5. **Bills Receivable of ₹ 2,000 maturing after 31st March were discounted.**
6. **Depreciation on Furniture to be charged at 10% on Written Down Value.**
7. **Interest on Debentures for the half year ending on 31st March was due on that date.**
8. **Provide Provision for taxation ₹ 4,000.**
9. **Technical Knowhow Fees is to be written off over a period of 10 years. Entire Preliminary Expenses to be written off.**
10. **Salaries and Wages include ₹ 10,000 being Director's Remuneration.**
11. **Sundry Debtors include ₹ 6,000 Debts due for more than six months.**

Keeping in mind the requirements of Schedule VI of the Companies Act, 1956, draw up the P & L A/c and Balance Sheet of the Company as close thereto as possible. Previous Year Figures can be ignored. [16]

Solution:

Balance Sheet of Jagadguru Ltd as on 31st March, 2014

	Particulars	Note	This Year	Prev. Yr
I	**EQUITY AND LIABILITIES:**			
(1)	**Shareholders' Funds:**			
	(a) Share Capital	**1**	4,00,000	
	(b) Reserves and Surplus	**2**	22,050	
(2)	**Non-Current Liabilities:**			
	Long Term Borrowings	**3**	1,50,000	
(3)	**Current Liabilities:**			
	(a) Short Term Borrowings	**4**	1,50,000	
	(b) Trade Payables - Sundry Creditors		87,850	
	(c) Other Current Liabilities	**5**	9,750	
	Total		**8,19,650**	
II	**ASSETS**			
(1)	**Non-Current Assets**			
	(a) Fixed Assets:(i) Tangible Assets	**6**	3,83,300	
	(ii) Intangible Assets	**7**	1,35,000	
	(b) Non-Current Investments (Shares at Cost)		50,000	
(2)	**Current Assets:**			
	(a) Inventories - Stock-in-Trade		1,42,500	
	(b) Trade Receivables	**8**	90,850	
	(c) Cash and Cash Equivalents - Cash on Hand		12,000	
	(d) Short Term Loans and Advances - Income Tax (Paid 10,000 – Prov. 4000)		6,000	
	Total		**8,19,650**	

Note: Contingent Liabilities: Bills Receivable discounted with Bank ₹ **2,000.**

Profit and Loss A/c of Jagadguru Ltd for the year ended 31st March, 2014

	Particulars	Note	This	Prev. Yr
I	Revenue from Operations		7,70,350	
II	Other Income (Dividend Income)		4,250	

III	**Total Revenue (I + II)**		**7,74,600**	
IV	**Expenses:** (a) Purchases of Stock-In-Trade (5,90,500 - Advertisement Exps. 5000) (b) Changes in Inventories of Finished Goods / Work - in-Progress & Stock-In - Trade (₹1,45,200 - ₹1,42,500) (c) Employee Benefits Expense (d) Finance Costs (e) Depreciation &. Amortization Expense (f) Other Expenses	 **9** **10** **11**	 5,85,500 2,700 40,000 17,300 3,700 1,15,850	
	Total Expenses		**7,65,050**	
V	Profit Before Exceptional & Extraordinary Items and Tax (III - IV)		**9,550**	
VI	Exceptional Items		**-**	
VII	Profit Before Extraordinary Items and Tax (V - VI)		**9,550**	
VIII	Extraordinary Items		**-**	
IX	Profit Before Tax (VII- VIII)		**9,550**	
X	Tax Expense: (a) Current Tax (b) Deferred Tax		 4,000 -	
XI	Profit / (Loss) for the period from Continuing Operations (IX - X)		**5,550**	
XII	Profit / (Loss) from Discontinuing Operations		**-**	
XIII	Tax Expense from Discontinuing Operations		**-**	
XIV	Profit / (Loss) from Discontinuing Operations (After Tax) (XII -		**-**	
XV	Profit / (Loss) for the period (XI + XIV)		**5,550**	
XVI	Earnings per Equity Share - Basic - Diluted		**₹0.28** **₹0.28**	

Note 1: Share Capital

Particulars	This Year	Prev.
Authorised: 30,000 Equity Shares of ₹10 each 2,000 6% Preference Shares of ₹ 100 each	 3,00,000 2,00,000	
Issued, Subscribed & Paid up: 20,000 Equity Shares of ₹100each 2,000 6% Preference Shares of ₹ 100 each	 2,00,000 2,00,000	
Total	**4,00,000**	

Note 2: Reserves and Surplus (showing appropriations and transfers) (all figures for this year)

Particulars	Opg. Bal.	Additions	Deductions	Clg. Bal
Surplus (P & L A/c)	**28,500**	**5,550**	Preference Dividend (2 Lakhs x 6%) = **12,000**	**22,050**

Note 3: Long Term Borrowings

Particulars	This Year	Prev. Yr
5% Mortgage Debentures (Secured against Freehold Premises)	1,50,000	

Note 4: Short Term Borrowings

Particulars	This Year	Prev. Yr
Secured Borrowings: Loans Repayable on Demand From Banks (Secured by Hypothecation of Stocks & Receivables)	1,50,000	
Total	**1,50,000**	

Note 5: Other Current Liabilities

Particulars	This Year	Prev. Yr
Interest Accrued and due on Borrowings (5% Debentures) Preference Dividends Payable (Total 12,000 - Interim Dividend Paid 6,000)	3,750 6,000	
Total	**9,750**	

Note 6: Tangible Fixed Assets

Item	Gross Block / Cost			Depreciation				Net Block / WDV
	Opg Bal.	Addns / (Dedns)	Clg Bal.	Opg Bal.	Addns / (Dedns)	Clg Bal.	As at Yr Beginning	As at Yr End
Column	**(1)**	**(2)**	**(3)=1± 2**	**(4)**	**(5)**	**(6)=4±5**	**(7)=1-4**	**(8)=3-6**
Furniture			52,000 **(Note)**	15,000	3,700 **(Note)**	18,700		33,300
Freehold Property			3,50,000					3,50,000
Total			**4,02,000**	**15,000**	**3,700**	**18,700**		**3,83,300**

Note:

1. In the absence of Information, the Other Columns in the above Table are not filled.

2. Furniture (Gross Block and Depreciation)

Particulars	₹
Furniture at Cost **Less** Depreciation ₹ 15,000 (as given in Trial Balance) **Add back:** Depreciation	35,000 15,000
Cost of Furniture **Add:** Installation Charge of Electrical Fittings wrongly included under the heading Salaries and Wages	50,000 2,000
Total Gross Block of Furniture A/c	**52,000**

Particulars	₹
Accumulated Depreciation Account: Opening Balance - given in Trial Balance **Add:** Depreciation for the year: On Opening WDV at 10% i.e. (10% x 35,000) On additions during the year at 10% i.e. (10% x 2,000)	15,000 3,500 200
Accumulated Depreciation at the end of the year	**18,700**

Note 7: Intangible Fixed Assets

Item	Gross Block / Cost			Amortisation			Net Block / WDV	
	Opg Bal.	+ /(-)	Clg Bal.	Opg Bal.	+ /(-)	Clg Bal.	Opg Bal.	Clg Bal.
Column	**(1)**	**(2)**	**(3)=1± 2**	**(4)**	**(5)**	**(6)=4±5**	**(7)=I-4**	**(8)=3-6**
Technical Knowhow			**1,50,000**			**15,000**		**1,35,000**

Note 8: Trade Receivables (assumed as Secured and considered good)

Particulars	This Year	Prev. Yr
Sundry Debtors (a) Debt outstanding for more than six months	6,000	
(b) Other Debts **(Note)**	44,850	
Bills Receivable (41,500 - 1,500)	40,000	
Total	**90,850**	

Calculation of Sundry Debtors - Other Debts

Particulars	₹
Sundry Debtors as given in Trial Balance	50,100
Add back: Bills Receivable Dishonoured	1,500
	51,600
Less: Bad Debt written off - 50% of ₹1500	(750)
Adjusted Sundry Debtors	50,850
Less: Debts due for more than 6 months (as per information given)	(6,000)
Total of Other Debtors i.e. Debtors outstanding for less than 6 Months	**44,850**

Note 9: Employee Benefit Expenses

Particulars	This Year	Prev. Yr
Amount as per Trial Balance	52,000	
Less: Wages incurred for installation of Electrical Fittings to be capitalized	2,000	
Less: Directors' Remuneration shown separately	10,000	
Balance to be shown in the P & L Account as "Salaries and Wages"	**40,000**	

Note 10: Finance Costs

Particulars	This Year	Prev. Yr
Interest on Bank Overdraft	7,800	
Interest on Debentures	7,500	
Discount on Issue of Debentures	2,000	
Total	**17,300**	

Note 11: Other Expenses

Particulars	This Year	Prev. Yr
Payment to the Auditors	5,000	
Directors Remuneration	10,000	
Selling Expenses	79,100	
Technical Knowhow written Off (1,50,000 ÷ 10)	15,000	
Preliminary Expenses	1,000	
Advertisement (Goods and Articles Distributed)	5,000	
Bad Debts (1,500 x 50%)	750	
Total	**1,15,850**	

(b)(i) Yama Limited made a Public Issue in respect of which the following information is available -

I. **Number of Partly Convertible Debentures issued = 4,00,000, Face Value and Issue Price ₹ 100 per Debenture.**
II. **Convertible Portion per Debenture = 60%, Date of Conversion = On expiry of 6 months from the date of closing of issue, Value of Equity Share for the purpose of conversion ₹60 (Face Value ₹ 10)**
III. **Date of Closure of Subscription Lists = 1st May, Date of Allotment = 1st June, Rate of Interest on Debentures = 15% payable from the date of allotment.**
IV. **Number of Debentures applied for = 3,00,000, Underwriting Commission = 2%**
V. **Interest Payable on Debentures half-yearly on 30th September and 31st March.**

Write relevant Journal Entries for all transactions arising out of the above during the relevant year ended 31st March, (including Cash and Bank entries). [8]

Solution:

Journal Entries in the books of Issuing Company

S.No	Date	Particulars	Dr. (₹)	Cr. (₹)
1.	1st May	Bank A/c Dr. To Debenture Application and Allotment A/c (Being application money recd on 3,00,000 Debentures at ₹ 100 each)	3,00,00,000	 3,00,00,000
2.	1st June	Debenture Application and Allotment A/c Dr. Underwriters A/c Dr. To 15% Debentures A/c (₹ 100 each) (Being allotment of 3,00,000 Debentures to applicants and balance 1,00,000 Debentures to Underwriters towards their liability)	3,00,00,000 1,00,00,000	 4,00,00,000
3.	1st June	Underwriting Commission A/c Dr. To Underwriters A/c (Being Commission Payable to Underwriters at 2% on ₹ 4,00,00,000)	8,00,000	 8,00,000
4.	1st June	Bank A/c Dr. To Underwriters A/c (Being amount received from Underwriters in settlement of A/c)	92,00,000	 92,00,000
5.	30th Sep	Debenture Interest A/c Dr. To Bank A/c (Being the interest paid on debentures for 4 months (1st June to 30th Sept) at 15% on ₹4,00,00,000)	20,00,000	 20,00,000
6.	31st Oct	15% Debentures A/c Dr. To Equity Share Capital A/c To Securities Premium A/c (Being conversion of 60% of Debentures into Equity Shares of ₹ 10, at ₹ 50 Premium, i.e. 4,00,000 shares)	2,40,00,000	 40,00,000 2,00,00,000
7.	31st Mar	Debenture Interest A/c Dr. To Bank A/c (Being Interest paid on Debentures for the second half-year) [(4,00,00,000 x 15% x 1/12) + (1,60,00,000 x 15% x 5/12)]	15,00,000	 15,00,000

(ii) The following are the changes in the account balances taken from the Balance Sheets of Shree Ganesh Ltd as at the beginning and end of the year -

Changes in ₹ in	Debit (₹)	Credit (₹)
Equity Share Capital 30,000 Shares of ₹10 each issued and fully paid		0
Capital Reserve		49,200
8% Debentures		50,000
Debenture Discount	1,000	
Freehold Property at Cost / Revaluation	43,000	
Plant and Machinery at Cost	60,000	
Depreciation on Plant and Machinery		14,400
Debtors	50,000	
Stock and Work-in-Progress	38,500	
Creditors		11,800
Net Profit for the year		76,500
Dividend Paid in respect of earlier year	36,000	
Provision for Doubtful Debts		3,300
Trade Investments at Cost	47,000	
Bank		70,300
Total	**2,75,500**	**2,75,500**

You are informed that,

- **Capital Reserve as at the end of the year represented realised profits on sale of one Freehold Property together with surplus arising on the revaluation of balance of Freehold Properties.**
- **During the year, Plant costing ₹18,000 against which Depreciation Provision of ₹13,500 was lying, was sold for ₹7,000.**
- **During the middle of the year, ₹50,000 Debentures were issued for cash at a discount of ₹ 1,000.**
- **The Net Profit for the year was after crediting the Profit on sale of Plant and charging Debenture Interest.**

Prepare a Cash Flow Statement which will explain why Bank Borrowing has increased by ₹70,300 during the year end. Ignore taxation. [8]

Solution:

Cash flow statement for the year ended …….(Indirect Method)

Particulars	₹	₹
A. CASH FLOW FROM OPERATING ACTIVITIES		
Net Profit before Taxation (given)	76,500	
Adjustments for: Depreciation **(WN 2)**	27,900	
Debenture Interest (50,000 x 8% x 6/12)	2,000	
Provision for Doubtful Debts	3,300	
Profit / Gain on Sale of Plant **(WN 1)**	(2,500)	
Operating Profit before Working Capital Changes	**1,07,200**	
Add /Less: Increase in Stock	(38,500)	
Increase in Debtors	(50,000)	
Increase in Creditors	11,800	
Net Cash Flow from / (used in) Operating Activities [A]		**30,500**
B. CASH FLOW FROM INVESTING ACTIVITIES		
Purchase of Plant & Machinery **(WN 3)**	(78,000)	
Purchase of Trade Investments	(47,000)	
Sale of Machinery	7,000	
Sale of Freehold Property (49,200 -43,000)	6,200	
Net Cash Flow from / (used in) Investing Activities [B]		**(1,11,800)**

C. CASH FLOW FROM FINANCING ACTIVITIES		
Proceeds from issue of 8% Debentures (50,000 - 1,000)	49,000	
Interest paid on 8% Debentures	(2,000)	
Dividends Paid in respect of earlier year	(36,000)	
Net Cash Flow from / (used in) Financing Activities [C]		**11,000**
D. Net Increase / (Decrease) in Cash and Cash Equivalents (A + B + C)		**(70,300)**
E. Cash and Cash Equivalents at the beginning of the year		**?**
F. Cash and Cash Equivalents at the end of the year		**?**

Working Notes:

1. **Profit on Sale of Plant** = Net Book Value (i.e. Gross Block less Accumulated Depreciation) **less** Sale Value
   = (18,000 - 13,500) less 7,000 = ₹2,500 Gain / Profit
2. **Depreciation for current year** = Increase in Depreciation as given above + Accumulated Depreciation on Plant Sold
   = 14,400 + 13,500 = ₹27,900
3. **Cash Outflow towards Assets Purchase** = Given increase in P&M at Cost + Gross Block on Plant Sold
   = 60,000 + 18,000 = ₹78,000

(c) The summarized Balance Sheet of Manoj Limited as at 31st March, 2013 is given below -

Liabilities	₹	Assets	₹
2,00,000 Equity Shares of ₹ 10 each, ₹ 5 paid	10,00,000	Fixed Assets	11,40,000
6,000 7% Preference Shares of ₹ 100 each	6,00,000	Patents and Copyrights	80,000
9% Debentures	6,00,000	Investments at Cost (Mkt Value ₹ 55,000)	65,000
Interest accrued on Debentures	1,08,000		
Bank Overdraft	1,50,000	Stock	4,00,000
Interest accrued on Bank Overdraft	15,000	Debtors	4,39,000
Current Liabilities: Creditors	69,000	Bank	10,000
		Profit & Loss Account	4,08,000
Total	**25,42,000**	**Total**	**25,42,000**

Note: Preference Dividend is in arrear for one year.

The following scheme is agreed upon -

1. **Preference Shareholders to give up 30% of their claims, including Dividends, and desire to be paid off.**
2. **Debentureholders give up their claims to interest in consideration of their interest being enhanced to 15%**
3. **Bank agrees to give up 50% of its interest outstanding in consideration of its being paid off at once.**
4. **Creditors would like to grant a discount of 5% if they are paid immediately.**
5. **Balance of Profit & Loss Account, Patents and Copyrights, and Debtors of ₹30,000 to be written off.**
6. **Fixed Assets to be written down by ₹34,000 and Investments are to reflect their Market Value.**
7. **To the extent not specifically stated, Equity Shareholders suffer on reduction of their rights.**
8. **Cost of Reconstruction is ₹7,550.**

Draft Journal Entries in the books of the Company assuming that the scheme has been put through fully with the Equity Shareholders bringing in necessary cash to pay off the parties, and to leave a Working Capital of ₹30,000 and prepare the Balance Sheet after reconstruction. [16]

Solution:

1. Cash/ Bank A/c (To compute Cash to be brought in by Equity Shareholders)

Particulars	₹	Particulars	₹
To balance b/d	10,000	By Preference Shareholders (70% x 6,42,000)	4,49,400
To Equity Share Capital **(Balancing Figure)**	7,00,000	By Bank Overdraft (1,50,000 + 7,500)	1,57,500
		By Creditors (95% x 69,000)	65,550
		By Reconstruction (Expenses)	7,550
		By balance c/d **(Required)**	30,000
Total	**7,10,000**	**Total**	**7,10,000**

Note: This amount of ₹7,00,000 will be collected as Call Money on the 2,00,000 Partly Paid Equity Shares. Hence, amount called up per Share additionally = ₹ 3.50.

2. Journal Entries in the books of Manoj Ltd

S. No	Particulars	Dr. (₹)	Cr. (₹)
1.	8% Preference Share Capital A/c Dr. To Preference Shareholders A/c To Reconstruction A/c (Being 30% of Claim given up by Preference Shareholders as per approved Reconstruction scheme dated....)	6,00,000	 4,20,000 1,80,000
2.	Reconstruction A/c Dr. To Preference Shareholders A/c (Being 70% of Arrear Preference Dividend payable to Preference Shareholders now provided for, balance 30% waived as per scheme) (₹ 6,00,000 x 7% x 70%)	29,400	 29,400
3.	9% Debentures A/c Dr. Interest Accrued on Debentures A/c Dr. To 15% Debentures A/c To Reconstruction A/c (Being 9% Debentures converted into 15% Debentures, in consideration of waiver of interest, which is transferred to Reconstruction A/c)	6,00,000 1,08,000	 6,00,000 1,08,000
4.	Bank Overdraft A/c Dr. Interest Accrued on Bank Overdraft A/c Dr. To Bank a/c To Reconstruction A/c (Being Bank Overdraft paid off including 50% of accrued interest as per Reconstruction Scheme, interest waived credited to Reconstruction a/c)	1,50,000 15,000	 1,57,500 7,500
5.	Creditors A/c Dr. To Bank A/c To Reconstruction A/c (Being Creditors' claim discharged to the extent of 95% as per Scheme, the balance of 5% waived transferred to Reconstruction a/c)	69,000	 65,550 3,450
6.	Reconstruction A/c Dr. To Bank A/c (Being expenses of Reconstruction paid)	7,550	 7,550

7.	Bank A/c Dr. To Equity Share Capital A/c (Being amount received on 2,00,000 Equity Shares at ₹ 3.50 per Share as per Reconstruction Scheme) **(WN 1)**	7,00,000	 7,00,000
8.	Preference Shareholders A/c Dr. To Bank A/c (Being the amount due to Preference Shareholders discharged)	4,53,600	 4,53,600
9.	Reconstruction A/c Dr. To Profit and Loss A/c To Patents & Copyright A/c To Debtors A/c To Investment A/c To Fixed Assets A/c (Being Debit Balance of P & L a/c, Patents & Copyrights, Value of Debtors, Investments and Fixed Assets written off as per Reconstruction Scheme)	5,62,000	 4,08,000 80,000 30,000 10,000 34,000
10.	Equity Share Capital A/c Dr. To Reconstruction A/c (Being balance amount required in Reconstruction A/c, provided by reducing Equity Capital, ₹ 3,00,000 over 2,00,000 Shares i.e. ₹ 1.50 per Share written off) **(WN 3)**	3,00,000	 3,00,000

3. Reconstruction A/c

Particulars	₹	Particulars	₹
To Preference Shareholders (Arrears Dividend)	29,400	By 8% Preference Share Capital (30% waived)	1,80,000
To Bank (Reconstruction Expenses)	7,550	By Accrued Interest on Debentures (waived)	1,08,000
To Profit and Loss A/c(written off)	4,08,000	By Interest on Bank Overdraft - (waived)	7,500
To Patents & Copyrights (written off)	80,000	By Creditors (5% discount received)	3,450
To Debtors (written off)	30,000	By Equity Share Capital **(balancing figure)**	3,00,000
To Investment (reduced to Market Value)	10,000		
To Fixed Assets (written off)	34,000		
Total	**5,98,950**	**Total**	**5,98,950**

Note: Equity Share Capital should be reduced by ₹3,00,000 for 2,00,000 Shares, i.e. ₹ 1.50 per Share. Hence, Net Amount Paid Up per Share = Already Paid Up ₹5.00 + Call Money ₹3.50 - Reduced ₹1.50 = ₹ 7.00

4. Balance Sheet of Manoj Ltd (and Reduced) as at 31st March (after reconstruction)

	Particulars as at 31st March	Note	This Year	Prev. Yr
I	**EQUITY AND LIABILITIES: Shareholders' Funds:**			
(1)	Share Capital	**1**	14,00,000	
(2)	**Non-Current Liabilities:**			
	Long Term Borrowings - 12% Debentures (Secured)		6,00,000	
	Total		**20,00,000**	

II **(1)**	**ASSETS** **Non-Current Assets** (a)Fixed Assets: Tangible Assets (11,40,000 - Decr on Reconstrn 34,000) (b)Non-Current Investments (Cost 65,000, taken at Market Value)		11,06,000 55,000	
(2)	**Current Assets:** (a) Inventories - Stock-In-Trade (b) Trade Receivables - Sundry Debtors (c) Cash and Cash Equivalents		4,00,000 4,09,000 30,000	
	Total		**20,00,000**	

Note 1: Share Capital

Particulars	This	Prev.
Authorised: ....Equity Shares of ₹ 10 each and ....Preference Shares of.... Each		
Issued, Subscribed & Paid up: 2,00,000 Equity Shares of ₹10 each, ₹7 paid up	14,00,000	

Section C

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

(i) Outline the meaning of non-compliance under SA-250. [2]

Answer:

"Non-Compliance" refers to acts of omission or commission by the entity being audited, either intentional or unintentional, which are contrary to the prevailing laws or regulations.

Non-compliance does not include personal misconduct (unrelated to the business activities of the entity) by the entity's Management or employees.

SA-250 applies to audits of Financial Statements and does not apply to other engagements in which the Auditor is specifically engaged to test and report separately on compliance with specific laws or regulations.

(ii) Write a short note on Floating Assets. [2]

Answer:

Floating Assets mean those Current Assets that are manufactured or purchased during the normal course of business. They are held for a shorter period and may be converted into cash within a year.

Examples: Raw Materials, WIP, Finished Goods, Consumables, Debtors, Sundry Receivables.

Valuation:

(a) Stocks / Inventories shall be valued at lower of - (i) Cost, or (ii) Market Price.

(b) Sundry Debtors and Bills Receivable shall be valued at Net Realisable Value.

(iii) Distinguish between Prepaid Expenses and Expenses relating to previous year. [2]

Answer:

Prepaid Expenses	Expenses relating to the previous year
1. They represent expenditure already incurred, some portion or the whole of which relates to a period subsequent to the Balance Sheet date.	Expenses relating to the previous year are those expenses, which have to be accounted for in the period to which they relate.
2. They constitute expenses paid but relating to subsequent accounting periods.	They constitute expenses payable, relating to the current year.
3. They should be subtracted from the amount of expenditure debited to Profit and Loss Account, i.e. Paid **Less** Prepaid.	They should be added to the amount of expenditure debited to Profit and Loss Account, i.e. Paid Plus Payable.
4. They constitute Outstanding Assets and shown on the Asset Side under Current Assets.	They constitute Current Liabilities and should be disclosed on the Liability Side of the Balance Sheet.

(iv) The AOA of ABC Ltd do not authorize the Company to buy back its own Shares. However, a Special Resolution has been passed in General Meeting of the Company authorizing the buy-back. The Directors of the Company are of the opinion that even without authority in the AOA, the buy-back is possible due to Special Resolution passed in the General Meeting authorizing the buy-back. Comment. [2]

Answer:

As per Sec.77A(2), the buy-back should be - (a) authorized by the Articles of Association, and (b) sanctioned by a Special Resolution in a General Meeting of the Company. Merely passing the Special Resolution is not sufficient. Authorisation of buy-back by the AOA is a must. So, the contention of the Director is wrong.

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

(i) Define the term 'material' and explain why the concept of materiality is important to auditors. [8]

Answers:

Materiality is an expression of the relative significance or importance of a particular matter in the context of financial statements as a whole. A matter is material if its omission would reasonably influence the decisions of an addressee of the auditors' report; likewise a misstatement is material if it would have similar influence. Materiality may also be considered in the context of any individual primary statement within the financial statements or of individual items included in them. Materiality is not capable of general mathematical definition as it has both qualitative and quantitative aspects.

Materiality is an important concept for auditors, as it acknowledges the fact that accounts cannot be perfectly accurate, and so allows small errors. If accounts had to be perfectly accurate, auditors would have to check every transaction (even then it is unlikely the accounts would be perfectly accurate). However, materiality allows an auditor to check only a sample of items, as he will be relying on statistics and the fact that small items are unlikely to contain significant errors. In this way the number of items checked in an audit is a small percentage of the total transactions, and the audit is completed at a reasonable cost.

(ii)(a) X, a Director of KP Private Ltd is also a Director of another Company, viz. GP Private Ltd, which has not filed the annual accounts and annual return for last three years. X is of the opinion that he is not disqualified u/s 274(1)(g), and the Auditor should not mention disqualification remark in his Audit Report. Comment. [4]

Answer:

As per Sec. 227(3)(f), the Auditor's Report should state whether the Directors of the auditee Company are disqualified from being appointed as Directors u/s 274(l)(g) of the Companies Act.

As per section 274(1)(g), a person shall not be capable of being appointed as Director of a Company if such person is already a Director of a Public Company which -

(a) has not filed the annual accounts and annual returns for any continuous three financial years,
(b) has failed to repay its deposit or interest thereon on due date or redeem its debentures on due date or pay dividend and such failure continues for one year or more.

In the given case, the Company in default is M/s GP Private Ltd, a Private Limited Company. Hence, the provisions of Sec. 274(1)(g) are not applicable in the given case. The Director X is not disqualified u/s 274(1)(g) of the Act.

Conclusion: The Director's view that he is not disqualified u/s 274(1)(g) of the Act is correct. The Auditor need not mention the disqualification remark in his Audit Report.

(b) Outline the Internal Control aspects in relation to Fixed Assets. [4]

Answer:

(i) Authorisation for Capital Expenditure: Expenditure for purchase or in-house construction of fixed asset should be authorised by responsible officials. It should be evidenced by way of Board Resolution, Budget Sanction, Notes in the Asset File, etc.

(ii) Accounting for Assets: Fixed Assets purchased should be properly accounted for by making suitable entries in the Fixed Assets Register and also the General Ledger. While recording cost, revenue-capital distinction should be observed.

(iii) Ownership Rights: Documents evidencing the ownership e.g. Title deeds of properties, RC

Book for vehicles etc. should be in the custody of responsible officials. A tracking register may be used in case of deposit of ownership documents with Bankers / Lenders.

(iv) Asset Registers: Arrangements should be made for maintaining Plant and Property Registers. They should be frequently agreed with the relevant accounts and physically verified. Care should be taken to distinguish between Fixed Assets and Current Assets (e.g. A Company engaged in manufacturing and selling vehicles, may have vehicles as part of Fixed and Current Assets)

(v) Physical Verification: Arrangements should be made to ensure that Fixed Assets are properly maintained and applied in the service of the Company (e.g. by periodic physical checks as to their location, operation and condition)

(vi) Asset Transfers: Where Fixed Assets are transferred between branches or members of the same group, guidelines should be laid down in respect of pricing, depreciation and accounting.

(vii) Sale, Scrapping of Assets: Sale, scrapping or transfer of Fixed Assets should be properly authorised and evidenced. Receipts from such disposals should be controlled and properly dealt with in the accounts.

(viii) Safeguarding: Adequate insurance cover should be made available for all relevant Fixed Assets.

(ix) Depreciation: The accounting policy of the Company should specify the method and rate of depreciation. It should be properly authorised and evidenced. Responsible persons should carry out the calculation of depreciation and asset values.

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

(a) Mention the special points-to be considered in the audit of Consignment Transactions in the books of the Consignor. [12]

Answer:

The following matters deserve the Auditors' attention in the audit of Consignment Accounts –

i. Consignment Agreement

Ascertain and note the following terms and conditions -

- **Commission due** - manner of payment, adjustment, etc.
- **Risk of Bad Debts** - in case of del credere commission, Consignee has to bear the risk of bad debts, else, the bad debts are to be borne by the Consignor.
- **Reimbursement of Consignment Exps** - eligible expenses, extent of reimbursement.

ii. Goods sent on Consignment

- Verify the goods sent on consignment based on (a) Proforma Invoice, (b) Consignment day book, (c) Goods Outward Book, (d) Transport Documents, (e) Acknowledgement of the goods by the Consignee, and (f) Account Sales.
- Examine whether goods sent on consignment but not yet received by the consignee, i.e. goods in transit have been included in Closing Stock.
- Where goods are consigned not at cost but at an inflated price, see that the necessary adjustments to remove the loading are made at the end of the year.

iii. Consignment Expenses

Verify the expenses of consignment by reference to the source documents –

- **Packing Expenses** - Based on supporting bills and vouchers.
- **Transportation Expenses** - Based on Freight Bills on "paid" basis.
- **Insurance during transit** - Based on Policy Copy and Premium Receipts.
- **Expenses reported** by Consignee and Commission due to him - Based on Account Sales and Consignment Agreement.

iv. Sales

- Verify the sales credited to the Consignment Account based on the Account Sales received from the consignee.
- Perform quantitative reconciliation and confirm whether sale proceeds of all goods have been properly reported.
- Verify whether the extent of loss / wastage reported, if any, is within the normal limits.
- In case the agreement stipulates sale by consignee at a fixed price, verify whether this condition has been adhered to.

v. Closing Stock

- See that necessary adjustments are made at the year-end in respect of the unsold goods i.e. Closing Stocks, Stocks in Transit, etc.
- See whether the closing stock has been valued consistently at Cost, as per generally accepted accounting principles i.e. Cost of Goods + Proportionate Direct Expenses incurred by Consignor and Consignee in bringing the goods to their present location and condition.

vi. Balance in Consignee's Account

- Verify whether the balance shown in the Statement of Account sent by the Consignee, agrees with the amount disclosed in the Balance Sheet. Ascertain reasons for differences, e.g. remittances in transit, etc.

Financial Statements

- Verify whether the Consignment Transactions have been properly reflected in the Financial Statements, i.e. (a) Profit on Consignment should be credited to General P &L Account and carried over to Balance Sheet and (b) Stock on Consignment and Amount due from the Consignee should be shown as "Assets".

(b)(i) Why is knowledge of business important? [6]

Answer:

Besides assisting auditor, the knowledge of business is important in:

- assessing inherent and control risk;
- considering business risks and management's responses thereto;
- developing the overall audit plan and audit programme;
- determining the materiality level and assessing its appropriateness;
- assessing the audit evidence to establish its appropriateness and the validity of the

related financial statements assertions;
- evaluating accounting estimates and management representations;
- identifying related parties and transactions with them;
- recognising unusual circumstances *(e.g.* fraud);
- making informed inquiries and assessing the reasonable of answers;
- considering the appropriateness of accounting policies and disclosures.

The auditor should ensure that the audit staff assigned to an audit engagement obtains sufficient knowledge of the business to enable them to carry out the delegated audit work.

(ii) Explain the matters that do and that do not affect the auditor's opinion. [6]

Answer:

Matters that do not affect the Auditor's Opinion: In certain circumstances, an auditor's report may be modified by adding an emphasis of matter paragraph to highlight a matter affecting the financial statements which is included in a note to the financial statements that more extensively discusses the matter. The addition of such an emphasis of matter paragraph does not affect the auditor's opinion. The paragraph would preferably be included preceding the opinion paragraph and would ordinarily refer to the fact that the auditor's opinion is not qualified in this respect.

The auditor should modify the auditor's report by adding a paragraph to highlight a material matter regarding a going concern problem where the going concern question is not resolved and adequate disclosures have been made in the financial statements.

The auditor should consider modifying the auditor's report by adding a paragraph if there is a significant uncertainty (other than going concern problem), the resolution of which is dependent upon future events and which may affect the financial statements. An uncertainty is a matter whose outcome depends on future actions or events not under the direct control of the entity but that may affect the financial statements.

Matters that do affect the Auditor's Opinion: An auditor may not be able to express an unqualified opinion when either of the following circumstances exists and, in the auditor's judgment, the effect of the matter is or may be material to the financial statements:

(a) there is a limitation on the scope of the auditor's work; or
(b) there is a disagreement with management regarding the acceptability of the accounting policies selected, the method of their application or the adequacy of financial statement disclosures.

The circumstances described in (a) could lead to a qualified opinion or a disclaimer of opinion. The circumstances described in (b) could lead to a qualified opinion or an adverse opinion.

(c) (i) Write short notes on Independence of Internal Auditor. [4]

Answer:

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

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

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

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

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

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

(ii) Lehar Ltd installed a new Water Treatment Plant at its factory on 1.10.2008. The Company estimated that the new plant will become obsolete after 4 years only and hence charged depreciation at a rate higher than that envisaged in Schedule XIV of the Companies Act. During the year 2008-09, the Company therefore, written off 1/4th of the cost. Comment on the above. [4]

Answer:

As per AS - 10, where the Management's estimate of useful life is shorter than that prescribed by the Statute, Depreciation on such Fixed Assets may be charged at a higher rate, i.e. as estimated by the Management.

The rates prescribed under Schedule XTV constitute only the minimum rates, and the Company can adopt a rate higher than that prescribed under Schedule XIV.

Hence, in the above case, the Company can write off a higher amount of depreciation. However, this should be properly disclosed in the Financial Statements and supporting Schedules / Notes.

(iii) How will you disclose Contingent Liability in the Balance Sheet of a Company? [4]

Answer:

Disclosure Requirements under Companies Act: Schedule VI, Part I of the Companies Act requires disclosure of a Contingent Liability by way of a Footnote to the Balance Sheet, specifying the general nature and the amount of each Contingent Liability. The Act requires disclosure of following liabilities by way of a Note -

(a) Claims against the Company not acknowledged as debts,
(b) Uncalled Liability on Shares partly paid,
(c) Arrears of Fixed Cumulative Dividend,
(d) Estimated amount of contracts remaining to be executed on Capital Account and not

provided for,

(e) Other moneys for which the Company is contingently liable.

Note: The amount of any guarantees given by the Company on behalf of Directors or other Officers of the Company shall be stated and where practicable, the general nature of each such Contingent Liability if material, shall also be specified.

Disclosure Requirements under AS - 29: Unless the possibility of any outflow in settlement is remote, the following should be disclosed for each class of Contingent Liability, as on the Balance Sheet date -

(a) Brief description of the nature of Contingent Liability; and

(b) Where practicable -

- An estimate of its financial effect, measured under Para 35 - 45 of AS - 29;
- An indication of the uncertainties relating to any outflow, and
- The possibility of any reimbursement.

Note: Where any of the information required as above is not disclosed because it is not practicable to do so, the fact should be stated.