INTERMEDIATE EXAMINATION
GROUP II
(SYLLABUS 2012)

SUGGESTED ANSWERS TO QUESTIONS
JUNE 2014

Paper-12: COMPANY ACCOUNTS AND AUDIT

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

The figures in the margin on the right side indicate full marks.

The paper is divided in three sections. From Section A, answer to Question No. 1 is compulsory.
From Question No. 2(a), (b) and (c) any two questions to be answered.
From Section B, answer to Question No. 3 is compulsory. From Question No. 4(a), (b) and (c) any two questions to be answered.

From Section C, answer to Question No, 5 is compulsory. From Question No. 6(a) and (b) one question to be answered and from Question no. 7(a), (b) and (c)any two questions to be answered.
(Whenever necessary relevant assumptions may be made and disclosed by way of note. Working Notes should form part of answer.)

Section A

1. (Compulsory) Answer the following: 2x2=4

(a) State the two main accounting assumptions, on which financial statements are prepared and presented.

(b) State the types of lease to which AS-19 are not applicable.

Answer:

1. (a) Main two accounting assumptions for the preparation and presentation of financial statements are
   (i) Accrual Assumption
   (ii) Going concern Assumption

   (b) The Accounting Standard AS-19 is not applicable to the following types of Lease:
   - Lease agreement to explore natural resources such as oil, gas, timber, metal and other material rights;
   - Licensing agreements for motion picture film, video recording, plays, manuscripts , patents and other rights;
   - Lease agreement to use land.

2. Answer any two questions from (a), (b) and (c): 8x2=16

(a) (i) Jayakrishna Mills Ltd., runs a modern wheat flour mill. The CFO has prepared the draft accounts, duly considering the mandatory accounting standards. Following note appears: "The company purchased on 15.6.2013, a special purpose machinery for ₹ 75 lakhs. It received a State Government grant for 10% of the price. The machine has an effective life of 10 years".
What is the proper method of accounting treatment for the above? 4

(ii) Springlily Ltd. borrowed US $ 6,00,000 on 31.12.2013 which will be repaid (settled) as on 30.6.2014. The company prepares its financial statements ending on 31.3.2014.
Rate of exchange between reporting currency (Rupee) and foreign currency (US $) on different dates are as under:

31.12.2013	**1 US $ = ₹ 64.00**
31.03.2014	**1 US $ = ₹ 64.50**
30.06.2014	**1 US $ = ₹ 64.75**

State the aspects to be noted while preparing the financial statements due to the applicable AS. How should the difference in exchange rates be treated? 4

(b) (i) State the disclosure requirements under AS-15. 3

(ii) What are the components of pension expenses for defined benefit pension plan? 5

(c) (i) What are the requirements to be considered by an enterprise by AS-26 as regards each class of provisions? 5

(ii) In 2012-13, ABC Pharma Ltd. had spent and carried forward in the books a total sum of ₹ 7,00,000 on developing a cure for rheumatism. During the current year, i.e. 2013-14, it is decided to terminate this product, since the test results in the current year have proved adverse.
What will be the treatment of the following in the final statement of accounts for the year ended 31.3.2014, of ABC Pharma Ltd.? 3

Answer:

2. (a) (i) Treatment of Govt. grant received for fixed asset:

AS-12 prescribes two methods of accounting treatment of Government grants for specific fixed assets.

Method I: Government grants related to depreciable fixed assets to be treated as deferred income which is to be recognized in the Profit and Loss Account in proportion in which depreciation on those assets is charged over the useful life of the asset.
The deferred income pending its apportionment to Profit and Loss Account to be disclosed in the balance sheet separately with a suitable description, it is to be shown as a part of "Long-Term Borrowings" as "Other loans and advances" (Nature- Deferred Grant) as per Revised Schedule VI.

Method 2: Grants received specifically for Fixed Asset may be disclosed in the financial statement by way of deduction from the gross block of the asset concerned, thus grant is recognised in P/L Account through reduced depreciation.

In this case machinery will be recognised at ₹ 67.5 lakhs i.e. after deduction of ₹ 7.5 lakhs Govt. Grants. And depreciation will be calculated on that ₹ 67.5 lakhs.

(ii) Treatment of loans obtained in foreign currency:

As per para 9 of AS 11 "Changes in Foreign Exchange Rates", a foreign currency transaction should be recorded, on initial recognition in the reporting currency, by applying the foreign currency exchange rate between the reporting currency and the foreign currency at the date of the transaction. Accordingly, on 31.12.2013, borrowings will be recorded at ₹ 3,84,00,000 (i.e. $ 6,00,000 x ₹ 64.00)

As per para 11(a) of the standard, at each balance sheet date, foreign currency monetary items should be reported using the closing rate. Accordingly, on 31.03.2014, borrowings (monetary items) will be recorded at ₹ 3,87,00,000 (i.e. $ 6,00,000 x ₹ 64.50).

The exchange difference of ₹ 3,00,000 is arising because the transaction has been reported at different rate (₹ 64.50 = 1 US $) from the rate initially recorded(i.e. ₹64 = 1 US $). This difference is taken to P&L account.

When the loan is closed, the liability will be higher by ₹ 1,50,000 i.e. $[(₹64.75 - ₹64.50) \times \$6,00,000$. The exchange difference of ₹ 1,50,000 is arising because the transaction has been settled at an exchange rate (₹ 64.75 = 1 US $) different from the rate at which reported in the last financial statement (₹ 64.50 = US $). This difference is also taken to P&L A/c.

(b) (i) Disclosure under AS-15:

(a) In view of the varying practices, there should be adequate disclosure of method of accounting for an understanding of the significance of such costs to an employer.
(b) Disclosure to be separately made for statutory compliance or otherwise the retirement benefit costs are treated as an element of employee remuneration without specific disclosure.
(c) Financial statements should disclose whether actuarial valuation is made at the end of the accounting period or earlier (if the date of actuarial valuation and the method used for accrual period is not based on actuary report).

(ii) The components of pension expenses for defined benefit pension plan are:

- Current service cost;
- Interest cost;
- Actuarial gains and losses;
- Past service cost;
- The effect of any curtailment re-settlements;
- Effect of recognition of over funding (assets) of defined benefit plan at lower of over funding amount and present value of any economic benefits available in the plan or reduction in future contribution to the plan;
- Expected return on any plan assets or any re-imbursement rights.

(c) (i) Disclosure of "Provisions" is covered under AS-29.

Disclosure requirements under AS-29 for provisions:

For each class of provision, an enterprise should disclose:
(a) the carrying amount at the beginning and end of the period;
(b) additional provisions made in the period, including increases to existing provisions;
(c) amounts used (i.e. incurred and charged against the provision) during the period; and
(d) unused amounts reversed during the period.

An enterprise should disclose the following for each class of provision:

(a) a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits;
(b) an indication of the uncertainties about those outflows. Where necessary to provide adequate information, an enterprise should disclose the major assumptions made concerning future events; and
(c) the amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement.

(ii) Treatment of intangibles:

As per para 87 of AS 26, an intangible asset should be derecognised on disposal or when no future economic benefits are expected from its use and subsequent disposal.
As per para 88 of AS 26, gains or losses arising from the retirement or disposal of an intangible asset should be recognised as income or expense in the Statement of Profit and Loss.
In this case, however, the company decided ultimately to discontinue the product due to adverse test result. The entire amount of ₹ 7 lakhs should be treated as an expense which should be adjusted against current year's P&L A/c.

Section B

3. (Compulsory) Answer the following: 2x4=8

(a) What is surrender of shares? What is the accounting treatment in the books of a company for surrender of shares?

(b) Name four items which are required to be disclosed under the head 'Inventories' as per schedule vi disclosure requirement.

(c) State the two major methods of accounting used for Mergers.

(d) State the objects of the issue of debentures according to the guidelines issued by the Controller of Capital Issues.

Answer:

3. (a) Surrender of shares

After the allotment of shares, sometimes a shareholder is not able to pay the further calls and returns his shares to the company for cancellation. Such voluntary return of shares to the company by the shareholder himself is called surrender of shares.

Surrender of shares has no separate accounting treatment but it will be like that of forfeiture of shares. The same entries (as are passed in case of forfeiture of shares) will be passed in case of surrender of shares.

(b) Disclosure requirement in respect of Inventories:

Disclosure requirements will mainly dwell upon, namely:
- Raw Materials
- Work in Progress
- Finished Goods
- Stock in Trade (in respect of goods acquired for trading)
- Stores and Spares
- Loose Tools
- Others (Specify nature)

(c) Methods of accounting used for Mergers

(i) Pooling of interest method, and
(ii) Purchase method.

(d) Objects of the issue of debentures

According to the guidelines issued by the Controller of Capital Issues, the objects of the issue can be among other things:
(i) Setting up of new projects;
(ii) Expansion or diversification of existing projects;
(iii) Normal capital expenditure for modernization;
(iv) To augment long-term resources of the company for working capital requirements;
(v) Merger/Amalgamation of companies in pursuance of schemes approved by banks, financial institutions and/or any legal authority.

4. Answer any two questions from (a), (b) and (c): 16x2=32

(a) (i) The following was the summarized financial position of Chanakya Ltd. as on 31st. March, 2014:

Equity & Liabilities	₹ Lakhs	Assets	₹ Lakhs

Share Capital:		Fixed Assets	15,000
Equity Shares of ₹ 10 each fully Paid Up	7,000	Investments	3,000
10% Redeemable Pref. Shares of ₹ 10 each fully Paid Up	3,000	Cash at Bank	1,450
		Other Current Assets	7,550
Reserve & Surplus:			
Capital Redemption Reserve	1,100		
Securities Premium	700		
General Reserve	5,800		
Profit & Loss Account	500		
Secured Loans:			
9% Debentures	4,000		
Current Liabilities:			
Trade Payables	3,800		
Sundry Provisions	1,100		
	27,000		27,000

On the 1st April, 2014 the Company redeemed all its Preference Shares at Premium of 10% and bought back 10% of its Equity Shares at ₹ 11 per Shares. In order to make funds available, the Company sold all the investments for ₹ 3,200 lakhs and raised a Bank Term Loan for the balance.

You are required to prepare the Balance Sheet of the Company after the redemption/buy back of shares. Assume that the securities premium account was utilised to the maximum possible extent. **10**

(ii) From the following informations, calculate the Commission payable to Mr. Rajan, the Managing Director of Securities India Ltd.

Profit as per the Profit and Loss A/c. is ₹ 1,45,09,000 after deducting the depreciation of ₹ 1,24,24,000. Salary and remuneration to the Managing Director of ₹ 72,000 and Director fees of ₹ 4,000. The depreciation as per u/s 350 of the Companies Act, 1956 is of ₹ 1,04,24,000. **6**

(b) (i) On January 1, 2004 Vardhaman Ltd. allotted 20,000, 9% Debentures of ₹ 100 each at par, the total amount having been received along with applications.

(1) On 1st Feb., 2005 the Company purchased in the open market 2,000 of its own debentures @ ₹ 102 each and cancelled them immediately.

(2) On 1st January, 2008 the Company redeemed at per debentures for ₹ 3,00,000 by draw of a lot.

(3) On 1st June, 2010 the Company purchased debentures of the face value of ₹ 2,00,000 for ₹ 1,97,800 in the open market, held them as investments for one year and then cancelled them.

(4) Finally, as per resolution of the Board of Directors, the remaining debentures were redeemed at a premium of 3% on 1st Feb., 2014 when Securities Premium Account in the company's ledger showed a balance of ₹ 50,000.

Pass journal entries for the above mentioned transactions ignoring debentures redemption reserve, debenture-interest and interest on own debentures. **10**

(ii) The following particulars relate to a Varahamihira Pipes Limited which has gone

into voluntary liquidation on 31.3.2014.
Share Capital issued:
6,000 Preference share of ₹ 100 each fully paid up.
45,000 Equity Shares of ₹ 10 each fully paid up.
20,000 Equity Shares of ₹ 10 each, 7 paid up.

Assets realised ₹ 14,00,000 excluding the amount realized by sale of securities held by partly secured creditors.

Particulars	Amount (₹)
Preferential Creditors	40,000
Unsecured Creditors	11,00,000
Partly Secured Creditors (Assets realized ₹ 2,20,000)	2,75,000
Debenture holders having floating charge on all	
Assets of the company	5,00,000
Expenses of Liquidation	22,000

A call of ₹ 3 per share on the partly paid equity shares was duly received except in case of one shareholder owning 1000 shares.

You are required to prepare the Liquidator's Statement of Account allowing for his remuneration @ 3% on all assets realized excluding call money received and 2% on the amount paid to unsecured creditors including preferential creditors.

Also calculate the percentage of amount paid to the unsecured creditors to the total unsecured creditors. 6

(c) (i) Given below is the information regarding five different segments of M/s. Varun Ltd. (₹ in lakhs)

Segments	P	Q	R	S	T	Total
Segmental Revenue	100	300	200	100	300	1,000
Segment Result	40	(60)	90	10	(30)	50
Segment Assets	45	55	140	20	40	300

As a Cost Accountant of the concerned company, the company management wants to know from you which company need to be reported. 6

(ii) Shyama Limited has given the following information for the preparation of cash flow statement for the year 2013-14

Particulars	₹ in 000
Net profit before tax	50,000
Dividend (including dividend tax) paid	17,070
Provision for income tax	10,000
Income tax paid during the year	8,496
Loss on sale of assets (net)	80
Book value of the assets sold	370
Depreciation charged during the year	40,000
Amortisation of capital grant	12
Profit on sale of investments	200
Cost of investment sold	55,530

Interest received on investments	**5,012**
Interest expenses	**20,000**
Interest paid during the year	**21,040**
Increase in Current Assets (excluding Cash & Bank balance)	**77,500**
Decrease in Current Liabilities	**34,650**
Purchase of Fixed Assets	**29,120**
Purchase of investment	**7,700**
Expenditure on construction work in progress	**69,480**
Receipt of grant for capital projects	**28**
Proceeds from issue of share capital	**51,960**
Proceeds from issue of Debentures	**41,150**
Opening Cash and Bank balance	**10,006**
Closing Cash and Bank balance	**13,976**

You are required to prepare the Cash Flow Statement for the year 2013-14 in accordance with AS-3. 10

Answer:

4. (a) (i)

Balance Sheet of Chanakya Ltd. as on1-4-2014(after Redemption and Buyback)

as per Revised Schedule VI (Extracts)

	Particulars	Note No	Amount (₹ Lakhs)
	EQUITY AND LIABILITIES		
(1)	Shareholders' Funds:		
	(a) Share Capital	1	6,300
	(b) Reserves and Surplus	2	7,930
(2)	Non-Current Liabilities (a) Long Term Borrowings	3	4,870
(3)	Current Liabilities (a) Trade payables		3,800
	(b) Short Term Provisions		1,100
	Total		24,000
(II) (1)	ASSETS Non-Current Assets		
	Fixed Assets		15,000
	Current Assets:		
	(a) Cash and Cash equivalents (W N)		1,450
	(b) Other Current Assets		7,550
	Total		24,000

Notes of Accounts
(Related Notes)

		₹ In Lakhs		
1.	Share Capital 630 lakh Equity Shares of ₹10 each Fully Paid up (70 lakh Equity Shares bought back)			6,300
2.	Reserve and Surplus General Reserve	5,800		

	Less: Transfer to CRR	3,700	2100	
	Capital Redemption Reserve			
	Add: Transfer due to buy-back of shares from Gen.res.		4800	
	Securities premium			
	Less: Adjustment for premium paid on redemption of preference shares	1,100		
	Less: Adjustment for premium paid on buy back	3,700	330	
	P&L A/c	700		
	Add: Profit of sale of investment	300	700	7,930
3.	Long-term borrowings	70		
	Secured	500		
	9% Debentures	200		
	Terms Loans-From Banks			4870
			4000	
			870	

Working Note:

Bank Account

Dr. Cr.

Particulars	Amount (₹ Lakhs)	Particulars	Amount (₹ Lakhs)
To balance b/d	1,450	By Preference Shareholders A/c	3,300
To Investment A/c (Sale Proceeds)	3,200	By Equity Shareholders A/c	770
To Bank Loan A/c (Loan received)	870	By Balance C/d (Balancing Figure)	1,450
	5,520		5,520

(ii)

Computation of Commission payable to the Managing Director

Particulars	₹ in '000	
	Amount	Amount
Profit as per Profit and Loss Account		14,509
Add: Depreciation charged to P/L A/c	12,424	
Salary and remuneration to the Managing Director	72	
Director's Fees	4	12,500
		27,009
Less: Depreciation u/s 350 of the Companies Act		(10,424)
Profit u/s 349 for the purpose of Managerial Remuneration		16,585
Managerial Remuneration 5%		829
Less: Salaries and Remuneration paid(Directors fees is excluded		(72)
Maximum Commission Payable to the Managing Director		757
Commission to be provided for at 1% of the Net Profits (1% of ₹ 16,585)		166

(b) (i)

Journal Entries

Date	Particulars	Debit (₹)	Credit (₹)

1.1.04	Bank A/c Dr. To Debenture Application and Allotment A/c (Being amount received on issue of ₹ 20,000, 9% debentures @ ₹ 100 each).	20,00,000	 20,00,000
1.1.04	Debenture Application and Allotment A/c Dr. To 9% Debentures A/c (Being Allotment of 20,000, 9% Debentures ₹ 100 each)	20,00,000	 20,00,000
1.2.05	Investment in Own 9% Debenture A/c Dr. To Bank A/c (Being, own debenture purchased)	2,04,000	 2,04,000
"	9% Debenture A/c Dr. Loss on Cancellation A/c Dr. To Investment in Own 9% Debenture A/c (Being , own debenture cancelled)	2,00,000 4,000	 2,04,000
1.1.08	9% Debenture A/c Dr. To Debenture Redemption A/c (Being, Amount due on redemption of debentures of ₹3,00,000)	3,00,000	 3,00,000
"	Debenture Redemption A/c Dr. To Bank A/c (Being, Amount paid on redemption of debentures of ₹3,00,000)	3,00,000	 3,00,000
1.6.10	Investment in Own 9% Debenture A/c Dr. To Bank A/c (Being, own debenture purchased, of the face value of ₹ 2,00,000 for ₹ 1,97,800)	1,97,800	 1,97,800
"	9% Debentures A/c Dr. To Investment in Own 9% Debenture A/c To Profit on Cancellation of own Debenture A/c (Being cancellation of own debenture)	2,00,000	 1,97,800 2,200
"	Profit on cancellation of Own Debenture A/c Dr. To Capital Reserve A/c (Being, transfer of profit on cancellation of own debentures to capital reserves)	2,200	 2,200
1.2.14	9% Debenture A/c Dr. Premium on Redemption A/c Dr. To Debenture Redemption A/c (Being the amount due on redemption of 9% Debenture at a premium of 3%)	13,00,000 39,000	 13,39,000
"	Debenture Redemption A/c Dr. To Bank A/c (Being, Payment on redemption of debentures)	13,39,000	 13,39,000
"	Securities Premium A/c Dr. To Premium on Redemption A/c (Being, utilisation of a part of Securities Premium A/c to write off premium paid on redemption of debentures)	39,000	 39,000

[No. of remaining debentures = 20,000 – 2,000 – 3,000 - 2,000= 13,000]

(ii)

Liquidators' Final Statement of Account

Dr. Cr.

Receipts	Amount (₹)	Payments	Amount (₹)
Sundry Assets realized (given)	14,00,000	Liquidator's Remuneration	65,980
Calls on Contributories: Equity Shareholders [(20,000 – 1,000)×₹3	57,000	Liquidation Expenses	22,000
		Debenture holders	5,00,000
		Preferential Creditors	40,000
		Unsecured Creditors: Partly Secured Creditors to the extent Unsecured (₹2,75,000-₹2,20,000)	55,000
		Fully Unsecured Creditors (balancing figure)	7,74,020
	14,57,000		14,57,000

Percentage of amount paid to unsecured creditors to total unsecured creditors:

$$\frac{₹55{,}000 + ₹7{,}74{,}020}{₹11{,}00{,}000(\text{Fully Unsecured}) + ₹55{,}000(\text{Partly Unsecured})} = 71.78\%.$$

Liquidator's Remuneration

Particulars	Computation	Amount (₹)
3% on all assets realized excluding Call Money, but including Sale of Securities held by Partly Secured Creditors	3%(₹14,00,000+₹2,20,000)	48,600
2% on amount paid to Preferential Creditors	$2\% \times 40{,}000$	800
Sub-Total of above (for considering balance Commission)		49,400
2% on amount paid to Other Unsecured Creditors (excluding Preferential Creditors)	As per Note =₹8,45,600 × $\frac{2}{102}$	16,580
Total Remuneration to Liquidators		65,980

Note:

Amount available for Unsecured Creditors & Liquidator's Remuneration = Gross Amount ₹14,57,000 less (Expenses ₹22,000 + Remuneration ₹49,400 (as per Sub-total above) + Debenture holders ₹5,00,000 + Preferential Creditors ₹40,000) = ₹8,45,600.

- ✓ Amount payable to partly Secured Creditors after setting off the assets realized, is considered as the unsecured amount, and hence considered for calculating total amount payable to unsecured creditors.
- ✓ Assets held by partly Secured Creditors are assumed to be realized by the liquidator himself, and hence taken into account for computing his remuneration.
- ✓ It is assumed that there is no List B Contributory available in respect of amount unrealized on call from one shareholder (₹ 3x 1,000)

(c) (i) Determination of Segments to be treated as reportable:

₹ in Lakhs

Particulars	P	Q	R	S	T	TOTAL
Segment Revenue	100	300	200	100	300	1,000
% of Segment Rev.	10%	30%	20%	10%	30%	
Segment Result: Profit/Loss	40	(60)	90	10	(30)	140/90
% of segment result, absolute amount of profit/loss whichever is higher, here, as a % of 140	28.57%	42.86%	64.29%	7.14%	21.43%	
Segment Assets	45	55	140	20	40	300
% of Segment Assets	15%	18.33%	46.67%	6.66%	13.33%	
Reportable Segment	Yes	Yes	Yes	Yes	Yes	
Criteria Satisfied	Revenue, Result & Assets	Revenue, Result & Assets	Revenue, Result & Assets	Revenue	Revenue, Result & Assets	

[All more than 10%.]

(ii)

Shyama Limited
Cash Flow Statement
For the year ended 31st March 2014

(₹ in lakhs)

	₹	₹
(A) Cash Flows from Operating Activities		60,000
Net Profit before taxation (₹ 50,000+₹10,000)		
Adjustment for:		
Depreciation	40,000	
Loss on sale of assets (net)	80	
Amortisation of capital grant	(12)	
Profit on sale of investments	(200)	
Interest received on investments	(5,012)	
Interest expenses	20,000	54,856
Operating profit before Working Capital Changes		1,14,856
Adjustment for changes in W.C - increase in Current assets		(77,500)
Changes in W.C - decrease in Current liabilities Cash		(34,650)
Generated from Operations		2,706
Income tax paid		(8,496)
Net cash used in Operating Activities		(5,790)
(B)Cash Flows from Investing Activities		
Sale of assets	290	
Sale of investments (₹ 55,530+₹200)	55,730	
Interest received on investments	5,012	
Purchase of fixed assets	(29,120)	
Purchase of investment	(7,700)	
Expenditure on construction work-in-progress	(69,480)	

Net Cash used in Investing Activities		(45,268)
(C)Cash Flows from Financing Activities		
Receipts of grant for capital projects	28	
Proceeds from issue of share capital	51,960	
Proceeds from issue of Debentures	41,150	
Interest paid	(21,040)	
Dividend(including dividend tax) paid	(17,070)	
Net Cash from Financing Activities		55,028
Net Increase in Cash and Cash Equivalents (A+B+C)		3,970
Cash and Cash Equivalents at the beginning		10,006
Cash and Cash Equivalents at the end		13,976

Section C

5. (Compulsory) Answer the following: 2x4=8

(a) What is test checking in Audit Work?

(b) State the duties of Auditor in respect of issue of Debentures as co-lateral security.

(c) Can a practicing Cost Accountant be appointed as statutory auditor of a private limited company by its shareholders in an Annual General Meeting?

(d) Why do the financial institutions demand Management Audit by companies, while participating in their equities?

Answer:

5. (a) Test checking is concerned with selecting and examining a representative sample from a large number of similar items. There is no hard and fast rule of selecting item for the test checking. The justification for the test checking lies in the theory of probability which states that a sample selected from a series of items will tend to exhibit the same characteristics as present in the full series of items.

(b) Duties of an Auditor in respect of issue of Debentures as co-lateral securities:

(i) The auditor should see that such debentures do not appear in the liabilities side of the balance sheet but are shown by way of note under the heading loan.
(ii) He should ensure that necessary entries made in the register of mortgages and that the necessary papers are filed with the registrar of companies.
(iii) He should also examine the loan agreement and confirm that it has been approved by the Board.

Alternative Answer:

(i) Debentures may be issued as collateral security to creditors, banks or other parties.

(ii) The collateral security becomes effective only in the event of default or loan not being repaid, when the loan is repaid, the debentures are automatically cancelled.
(iii) The auditor should read the loan agreement and confirm that the BOD has approved the issue.
(iv) Amount of the debentures is shown in an inner column of balance sheet, as the company is liable to the amount of loan and not the debentures issued as collateral security.

(c) Appointing practicing Cost Accountant as statutory auditor:

No. A practicing cost accountant is not qualified for appointment as statutory auditor of company, even of a private limited company.

(d) Management Audit:

Financial Institutions conduct the Management Audit while participating in equities of a company to avoid possible loss arising out of inefficient management. Financial Institutions also conduct Management Audit for following reasons –
(i) For investment in a company.
(ii) For granting loans to company.
(iii) For giving guarantee etc.

6. Answer either (a) or (b):

(a) (i) Is the system of propriety audit applied in respect of all public limited companies? 4
(ii) Discuss in brief, the principles, which are useful in assessing the reliability of audit evidence. 4

Or

(b) (i) As an auditor of a company, how will you verify the Research and Development costs of the Company. 4
(ii) What are the objects of verification of Assets and liabilities. 4

Answer:

6. (a) (i) Propriety audit is not applied in respect of all public limited companies:

The system of propriety audit is not applied in respect of all public limited companies. Propriety audit is an essential element of a Government Audit.

The term 'propriety' has been defined by Kholer as "that which meets the tests of public interest, commonly accepted customs and standards of conduct and particularly as applied to professional performance, requirements of Government regulations , and professional codes." The system of propriety audit is applied in respect to Government companies and Government departments because public money and public interest are involved therein.

In case of non-government companies, the auditor has to comment upon some of the propriety aspects in the transactions of the companies, for example under CARO 2003 pursuant to section 227 of Companies Act, 1956. Otherwise, non-

Government company auditors do not conduct propriety audit unlike in case of Government Companies.

(ii) Useful principles for assessing the reliability of audit evidence:

Audit evidence refers to any information, verbal or written, obtained by the auditor on which he bases his opinion on financial statements.
The reliability of audit evidence depends on its source-internal or external, and on its nature-visual, documentary or oral. While the reliability of audit evidence is dependent on the circumstances under which it is obtained, the following generalisations may be useful in assessing the reliability of audit evidence:

- External evidence (e.g. confirmation received from third party) is usually more reliable than internal evidence.
- Internal evidence is more reliable when related internal control is satisfactory.
- Evidence in the form of documents and written representations is usually more reliable than oral representations.
- Evidence obtained by the auditor himself is more reliable than that obtained through the entity.

(b) (i) The process of verifying expense/cost incurred in relation to "Research and Development Expenditure" is as follows:

- Ascertain the nature of research and development work to be carried out or that have already been carried out.
- If the expenses are routine development expenses, it should be seen that they are written off to the profit and loss account.
- Check whether the concerned research activity is authorized by the Board and has relevance to the objectives of the company.
- If any machinery and equipment have been bought specially for the purpose of research activity, the cost thereof, less the residual value should be appropriately debited to the Research and Development Account over the year of research.
- Ensure that the stipulations of AS-26 on Intangible Assets have been adhered to.
- Tax benefit arising on the research and development expenses should be taken into account in creating tax provision.
- No expense unrelated to the research and development programme should be allowed to be debited to Research & Development Account.

(ii) Verification of assets and liabilities is done with the following objects:

- To know whether the Balance Sheet exhibits a true and fair view of the State of affairs of the business.
- To find out whether the assets were in existence
- To find out the ownership and title of the assets
- To show correct valuation of assets and liabilities
- To verify the arithmetical accuracy of the books of accounts
- To ensure that the assets have been recorded properly
- To detect frauds & errors, if any
- To find out whether there is an adequate internal control regarding acquisition, utilization and disposal of assets.

7. Answer any two questions from (a), (b) and (c): 12x2=24

(a) (i) Bring out in a tabular form, the relationship between accounting and auditing. 4
(ii) State the aspects to be seen by an auditor to ensure that the statements audited project a true and fair view. 4
(iii) What is meant by cost audit? State the duties of a cost auditor. - 4

(b) (i) Tabulate the differences between statutory audit and forensic audit. 4
(ii) What is meant by Audit Note Book? State its importance. What are the contents of a typical Audit Note Book? 8

(c) (i) Tabulate the differences between a Checklist and Internal control questionnaire. 4
(ii) What are the matters to be considered while conducting the audit of a charitable institution? 8

Answer:

7. (a) (i) Relationship between accounting and auditing-

The relationship between accounting and auditing has been explained by Kell and Ziegler in "Modern Auditing" as follows:

	Accounting	Auditing
(i)	Analyze events and transactions	Review client's internal control system
(ii)	Record and summarize data in accounting records	Obtain and evaluate evidence on statement assertions.
(iii)	Make financial statement assertions	Determine fairness of statements in conformity with recognized accounting principles
(iv)	Prepare financial statements as per recognized accounting principles	Prepare audit report on finding
(v)	Distribute financial statements and Auditor's report to shareholders	Deliver audit report to client

(ii) True and fair view:

It must be noted that the disclosure requirements as laid down by the law are the minimum requirements. If certain information is vital for showing a true and fair view, the accounts should disclose it even though there may not be a specific legal provision to do so. Thus, what constitutes a true and fair view is a matter of an auditor's judgment in the particular circumstances of a case.
In more specific terms, to ensure true and fair view, an auditor has to see the following:
(i) That the assets are neither undervalued or overvalued, according to the applicable accounting principles;
(ii) No material asset is omitted;
(iii) The charge, if any, on assets are disclosed;
(iv) Material liability should not be omitted;
(v) The profit and loss account discloses all the matters required to be disclosed by Part II of Schedule VI and the balance sheet has been prepared in accordance with part I of Schedule VI;
(vi) All unusual, exception or non- recurring items have been disclosed separately.

(iii) Cost audit :

It is an audit process for verifying the cost of manufacture or production of any article, on the basis of accounts as regards utilisation of material or labour or other items of costs, maintained by the company.
In simple words the term cost audit means a systematic and accurate verification of the cost accounts and records and checking of adherence to the objectives of the cost accounting.

Cost Audit [u/s 233B]

The Central Government may, if it feels necessary, direct by an order that an audit of the cost records kept by a Company u/s 209(1)(d) shall be conducted by a Cost Accountant within the meaning of the Cost and Works Accountants Act, 1959 in such a manner as may be specified.

In cost audit, auditor has to perform the following duties -
- Examine the correctness of the cost records maintained by the concern and
- To report as to whether the cost accounting plans have been adhered to or not.

(b) (i) Differences between Statutory Audit and Forensic Audit:

	Statutory audit	Forensic audit
(i)	Express an opinion on the truthfulness and fairness of the Financial Statements.	Determine if any fraud has been committed in the client's business.
(ii)	Substantive and compliance procedures are used.	Substantive procedures, audit-in depth, trend, past-data analysis are used.
(iii)	Accounts relating to the relevant accounting year are checked.	Accounts may be checked for as many numbers of years as required to detect the cause of the fraud, if any.
(iv)	Check the arithmetical accuracy and compliance with procedures.	Propriety aspect is focused on.
(v)	Qualifications may be given in case of adverse findings.	The amount of fraud, the persons behind it and the legal implication are mentioned in the audit report.

(ii) Audit Note Book:

An audit note book is usually a bound book in which a large variety of maters observed during the course of audit are recorded. The audit note book is a permanent record of the auditor. For each individual audit, the auditor usually maintains a separate audit note book. The audit note book should be maintained clearly, completely and systematically.
An audit note book is a great evidential tool available as a defense with the auditors in the event of any charge is brought against them. In the case of City Equitable Fire Insurance Company, the auditors were relieved because they have maintained record of the audit work performed at each stage.

Contents of Audit Note Book-
(i) Name of the business enterprise;

(ii) Organisation structure;
(iii) Important provisions of Memorandum and Articles of Association;
(iv) Communication with the previous auditor, if any;
(v) Management representations and instructions;
(vi) List of books of accounts maintained by the enterprise;
(vii) Accounting methods, internal control systems followed by the enterprise, applicable laws, etc;
(viii) Key management personnel;
(ix) Errors and fraud discovered;
(x) Matters requiring explanations or clarifications;
(xi) Special points that need attention in the audit report and for subsequent audits;
(xii) Any significant changes taking place subsequent to the closing of accounts.

(c) (i) Differences between Checklist and Internal Control Questionnaire:

	Basis	Checklist	Internal Control Questionnaire
(i)	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.
(ii)	Issued To whom	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.
(iii)	Contents	It contains instructions to be followed by audit assistants.	It contains questions to be answered by the employees of the organization.
(iv)	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.

(ii) Matters to be considered while conducting audit of a charitable institution:

When conducting the audit of a charitable institution, the auditor should consider the following matters:
(a) The auditor should study the constitution of the charitable institution, for example, whether it is set up under the Societies Registration Act or as per section 25 of the Companies Act or as a trust.
(b) Obtain a list of members of the governing body. This will help the auditor in identifying whether any of the members of the governing body has any interest in the charitable institution.
(c) The auditor should obtain a copy of the budget sanctioned or the financial statement. This would enable him to acquaint himself with the different heads of income and expenditures of the institution.
(d) Examination of the system of internal check, especially as regards the accounting of the amounts collected.
(e) Check that the amounts received towards income have been duly collected, received and deposited into the bank regularly and promptly.
(f) These institutions receive subscriptions and donations which form the major part of their collections.

Therefore the auditor should check the following:

- The amount or the rate of the annual subscription.
- Any instructions given by the donors as to the specific utilization of donation.
- Adequacy of internal controls existing as regards unused receipt books, counter foils, etc.
- Where subscriptions are received in advance these should be properly dealt with in the accounts.

(g) Verify the amounts of legacies received by reference to correspondence with any figures and other available informations.

(h) Where the institution has made any investments or given loans, the amount of dividend and interest should be properly vouched with reference to the counterfoils or dividend warrants received. It should be ensured that such loans or grants are given under proper authorizations.

(i) If some property is given or taken on rent, then the auditor should check the tenancy agreement, the rent slips and the authorized person for the collection or payment, as the case may be, of the rent.

(j) Most of the organisations organize special functions such as concert etc. The auditor should be careful in such cases. All the gross receipts and outgoings are to be properly vouched by him. It should be ensured that proper internal check was maintained as regards the receipts and outgoings. For example, the person responsible for collection and disbursements should be separate persons.

(k) The expenditure of charitable institution is also one of the major areas of concern. Thus the auditor should verify that the expenditure is made only for the charitable purpose. If the expenditure is not for the charitable purpose, then the auditor should examine the implications of applicable law and document for the same.

(l) The auditor should physically verify the cash in hand, inventories and fixed assets.