INTERMEDIATE EXAMINATION

GROUP II

(SYLLABUS 2012)

SUGGESTED ANSWERS TO QUESTIONS

DECEMBER 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.

This paper contains four questions. All questions are compulsory, Subject to instruction provided against each question. All working must form part of your answer.

Assumptions, if any, must be clearly indicated.

1. Answer *all* questions: 2x10=20

(a) State the classification of cash flow activities as per AS-3.

(b) During the year 2013-14, Purvi Limited received a grant from the Government of India amounting to ₹35 lakh towards purchase of a piece of land for ₹140 lakh.

You are required to show the accounting treatment of the above transaction in the books of Purvi Limited, as per AS-12.

(c) Chandra Limited purchased a machinery of ₹10,00,000 from Machinery Mart. The consideration was paid in the form of fully paid up equity shares of ₹10 each at 60% premium. Pass necessary journal entries in the books of Chandra Ltd.

(d) What are the types of amalgamation as per AS-14?

(e) What are the various modes of buy-back of shares by a Limited Company?

(f) X Ltd. decides to redeem 650, 15% preference shares of ₹100 each at 10% premium. It has General Reserve of ₹45,500 and securities premium of ₹1,000. The new equity shares of ₹10 each are to be issued at 25% premium for the purpose of redemption of preference shares. Calculate the minimum number of equity shares to be issued by X Ltd.

(g) What is the basic difference between audit report and audit certificate?

(h) What do you understand by audit programme?

(i) State the three components of audit risk.

(j) Mention four situations where external confirmation may be useful for auditors.

Answer:

1. (a) Cash Flow Statement explains cash movements under three different heads, namely
   - Cash flow from operating activities;
   - Cash flow from investing activities;
   - Cash flow from financing activities

   (b) As per AS-12, accounting for Government Grants related to non- depreciable assets should be credited to capital reserve.

   Thus, in the Books of Purvi Limited: (₹ In Lakhs)

Accounting entries:		₹	₹
(i) On Purchase of Land			
Land A/c	Dr.	140	
To Bank A/c			140
(ii) On receipt of Govt. Grant			
Bank A/c	Dr.	35	
To Capital Reserve A/c			35

   (c) Journal of Chandra Ltd.

Particulars		**Dr. (₹)**	**Cr. (₹)**
Machinery A/c	Dr.	10,00,000	
To Machinery Mart			10,00,000
Machinery Mart	Dr.	10,00,000	
To E. S. Capital A/c			6,25,000
To Securities Premium A/c			3,75,000

   (d) AS-14 classifies amalgamation into following two types:

   (i) Amalgamation in the nature of merger

   (ii) Amalgamation in the nature of purchase

   (e) Various modes of Buy-back:

   Buy back is permissible

   - From the existing security holders on a proportionate basis through the tender offer, or
   - From the open market through
     - Book building process
     - Stock exchange
   - From odd lots, that is to say, where the lot of securities of a public company whose shares are listed on a recognised stock exchange is smaller than such market share lot, as may be specified by the stock exchange

- By purchasing the securities issued to employees of the company pursuant to a scheme of stock option or sweat equity.

(f) Nominal Value of Preference Shares +Premium on Redemption = Existing Securities Premium + Divisible Profits available for redemption + Sale Proceeds of fresh issue of New Shares

65,000+6,500 = 1,000+45,500 + X

X = 25,000

Minimum number of equity shares to be issued for redemption of preference share

= Sale Proceeds of fresh issue of New Shares/Issue Price= 25,000/12.50 = 2000

(g) The basic difference between audit report and audit certificate

(i) Audit report is an expression of opinion on the truth and fairness of the accounts.

(ii) Audit certificate is authentication of true and correctness of the data or fact certified.

(iii) The existence of opinion distinguishes a report from the certificate.

(h) An audit programme is a written plan containing exact details with regard to the conduct of a particular audit. It is a description or memorandum of the work to be done during an audit. Audit Programme serves as a guide in arranging and distributing the audit work as well as checking against the possibility of omissions.

(i) Three components of audit risks:

- Inherent risk (risk that material errors will occur)
- Control risk (risk that the client's system of internal control will not prevent or correct such errors); and
- Detection risk (risk that any remaining material errors will not be detected by the auditor).

(j) Four situations where external confirmation is useful to the auditors:-

- Bank balances and other information from bankers
- Account receivables balances
- Inventory held by third parties
- Account payable balances

2. Answer *any two* questions: 8x2=16

(a) Neel Limited issued 5,00,000 equity shares of ₹10 each, fully paid amounting to ₹50,00,000. It issued right shares among the existing shareholders, on 31 st July, 2013 in the proportion of one new share for two outstanding shares at ₹50 each. Market price of the company's share prior to right issue was ₹90. Net profit before tax for the year ending on 31st March, 2013 and 31st March, 2014 was ₹11,00,000 and ₹13,50,000 respectively. Corporate tax rate is 30%.

You are required to compute the basic earnings per share for the financial years 2012-13 and 2013-14. 8

(b) (i) Kachari Limited granted 25,000 employees stock options (face value ₹10) on 1st April, 2012 at ₹100, when the market price was ₹425. The options were to be exercised between 16th October, 2012 and 15th March, 2014. The employees exercised their options for 22,500 shares only. The remaining options lapsed. The company closes its books on 31st March every year. Pass Journal entries. 4

(ii) Hetarth Ltd. provides after sales warranty for 2 years to its customers. Based on the past experience, the company has the following policy for making provision for warranties on the invoice amount, on the remaining balance warranty period:

Less than 1 year: 2% provision

More than 1 year: 3% provision

The company has raised invoices as under:

Invoice Date	**Amount ₹**
19th January, 2012	**40,000**
29th January, 2013	**25,000**
15th October, 2013	**90,000**

Calculate the provision to be made for warranty under Accounting Standard 29 as at 31st March, 2013 and 31st March, 2014. Also compute amount to be debited to Profit and Loss Account for the year ended 31st March, 2014. 4

(c) (i) MN Ltd. acquired a patent at a cost of ₹90 lakh for a period of six years and the product life cycle is also six years. The company capitalized the cost and started amortising at ₹15 lakh per annum. After 3 years, it was found that the product life cycle may continue for another 5 years from then. The net cash flow from the product during these 5 years are expected to be ₹30 lakh, ₹45 lakh, ₹38 lakh, ₹35 lakh and ₹32 lakh.

Find out the amortization cost of the patent for each of the years as per AS-26. 5

(ii) From the following information, calculate the actual return on pension plan assets:

	₹	
Fair market value of plan assets on 1st April, 2013	**45,00,000**	
Fair market value of plan assets on 31st March, 2014	**51,20,000**	
Employer's contribution	**6,65,000**	
Benefit paid to retirees	**7,60,000**	**3**

Answer:

2. (a) Calculation of Theoretical Ex-Right Price

$$\frac{\text{Fair value of all outstanding shares immediately Prior to exercise of right} + \text{Total amount received from exercise of rights}}{\text{No. of shares outstanding Prior to exercise of right} + \text{No. of shares issued in the exercise}}$$

= (5,00,000 × ₹90) + (2,50,000 × ₹50)/(5,00,000 + 2,50,000)

= (4,50,00,000 + 1,25,00,000)/7,50,000

= ₹ 76.67

Adjustment Factor.

Fair value per share immediately prior to exercise of rights ÷ Theoretical Ex-right fair value per share

= ₹90 / ₹ 76.67 = 1.1739

Computation of EPS

Particulars	2012-13 (₹)	2013-14 (₹)
Profit before tax	1100000	1350000
Less: Corporate tax @30%	330000	405000
Profit after tax (profit attributable to equity shareholders)	770000	945000
EPS for 2012-13	770000/500000 = ₹1.54	--
EPS restated for 2012-13 for right issue = 770000/500000 ×1.1739	₹ 1.31	--
EPS for 2013-14 including right issue = 945000/[(500000 ×1.1739 × 4/12)+(750000 × 8/12)] = 945000/(195650 + 500000) = 945000/695650		₹ 1.36

2. (b) (i) **Journal of Kachari Limited**

01/4/12	Employee Compensation Expense A/c To Employee Stock Options Outstanding A/c (Being grant of 25000 stock options to employees at ₹100 when market price is ₹ 425)	Dr.	81,25,000	 81,25,000
(16/10/12 to 15/3/14)	Bank A/c Employee stock options outstanding A/c To Equity share capital A/c To Security premium A/c (Being allotment to employees of 22500 equity shares of ₹10 each at a premium of ₹415 per share in exercise of stock options by employees)	Dr. Dr.	22,50,000 73,12,500	 2,25,000 93,37,500
16/3/14	Employee stock options outstanding A/c To Employee compensation expense A/c (Being entry for lapse of stock options for 2500 Shares)	Dr.	8,12,500	 8,12,500
31/3/14	Profit & Loss A/c To Employee compensation expense A/c (Being transfer of employee compensation Expense to profit and loss account)	Dr.	73,12,500	 73,12,500

Note: Employee stock options outstanding will appear in the Balance Sheet as part of Net Worth or Shareholders' Equity.

2. (b) (ii)

A. Provision as on 31.03.2014 = [(₹25,000×0.03)+(₹90,000×0.02)]=₹(750+1,800) =₹2,250.
B. Provision as on 31.03.2013 = [(₹40,000×0.03)+(₹25,000×0.02)]=₹(1,200+500) = ₹1,700.
C. Amount debited to P/L A/c as on 31.03.2014 (A-B) = ₹ 550.

Note: No provision is to be made on 31.03.2014 in respect of sales amounting to ₹40,000 made on 19.01.2012 because the warranty period of 2 years has already expired.

2. (c)

(i) Total cost of the patent is ₹ 90 lakhs.

Amortisations for first 3 years = 90/6 = 15 x 3 = 45 lakhs

Unamortised amount of ₹ 90 lakhs - 45 lakhs = 45 lakhs to be written-off for next 5 years in proportion of cash flows from the product in these years. The amount to be written-off during next years calculated as follows:

(₹ In lakhs)

Year	Net Cash Flow (₹)	Amortisation Amount (₹)
4	30	45 x 30/180 = 7.5
5	45	45 x 45/180 = 11.25
6	38	45 x 38/180 = 9.5
7	35	45 x 35/180 = 8.75
8	32	45 x 32/180 = 8
Total	180	45

(ii) Computation of actual return on pension plan assets: ₹

		₹
Fair value of plan assets on 31.3.2014		51,20,000
Less: Fair value of plan assets on 1.4.2013		45,00,000
Change in fair value of plan assets		6,20,000
Adjustments:		
Employer's Contribution	₹ 6,65,000	
Less: Benefit paid to retirees	₹ 7,60,000	+ 95,000
Actual return on plan assets		7,15,000

3. Answer *any two* questions: 16x2=32

(a) (i) Masood Ltd. came out with an issue of 45 lakh equity shares of ₹ 10 each at a premium of ₹ 2 per share. The promoters took 20% of the issue and the balance was offered to the public. The issue was equally underwritten by P, Q and R respectively.

Each underwriter took firm underwriting of 1,00,000 shares each. Subscriptions for 31,00,000 equity shares were received with marked forms for the underwriters as given below:

P	7,25,000 shares
Q	8,40,000 shares
R	13,10,000 shares
	28,75,000 shares

The underwriters are eligible for a commission of 5% on face value of shares. The entire amount towards shares subscription has to be paid along with application. You are required to:

(1) Compute the underwriters' liability (number of shares);

(2) Compute the amount payable as due to underwriters; and

(3) Pass necessary Journal Entries in the books of Masood Ltd. relating to underwriters.

(Note: As per contract, the underwriters are to be given credit for 'firm' applications and that credit for unmarked applications be given in proportion to the shares underwritten.) 8

(ii) State the conditions for issue of Sweat Equity Shares. 4

(iii) There are two whole-time directors and three part-time directors in Pooja Limited. As per the Articles of the company, whole time directors are entitled to a commission @10% of the profits remaining after charging commission of the part-time directors and the part-time directors are entitled for a commission @1% of the profits remaining after charging the commission of the whole-time directors. The net profit of the company is ₹50,00,000 before charging any commission of whole-time directors and part-time directors.

You are required to find out the total remuneration payable to the whole-time directors and part-time directors, as per provisions contained in the Company's Articles. 4

(b) (i) The following are the items in the Balance Sheets of Ritu Limited and Richa Limited as on 31st March, 2014:

	Ritu Ltd. ₹ (lakhs)	Richa Ltd ₹ (lakhs)
Share Capital in ₹10 fully paid equity shares	5,000	2,000
Reserves and Surplus	5,000	3,000
Unsecured Loans	2,000	1,000
Creditors	1,000	500
Total:	13,000	6,500
Fixed Assets at Cost Less Depreciation	6,000	4,000
Current Assets	7,000	2,500
Total:	13,000	6,500

On 31st March, 2014, Ritu Limited absorbed Richa Limited by allotting its 5 equity shares for every 4 shares of Richa Limited, on the basis of intrinsic Values of their equity shares. Balance, if any, is paid by Ritu Limited in cash to Richa Limited to satisfy the amount of purchase consideration.

You are required to:

(1) Compute purchase consideration showing the number of equity shares issued by Ritu Limited and cash paid for balance amount to Richa Limited, if needed.

(2) Pass journal entries in the books of Ritu Limited. 8

(ii) Mogari Limited has 10% Redeemable Preference share capital of ₹30,00,000 consisting of ₹10 shares fully paid up. The company wants to redeem these shares at 25% premium. The ledger accounts show the following balances:

Securities premium ₹1,00,000; General Reserve ₹13,00,000 and Profit & Loss Account (Cr.) ₹7,00,000

In order to facilitate the redemption of preference shares, the company decided the following:

1. 1,20,000 Equity shares of ₹10 each were issued at 50% premium.
2. 10,000, 12% Debenture of ₹100 each were issued at par.
3. Investments of book value ₹5,00,000 were sold at ₹5,60,000.

Pass the necessary journal entries to record above transactions and redemption of preference shares. 8

(c) (i) Suku Limited went into voluntary liquidation. The details regarding liquidation are as follows:

Share Capital:

9,000, 10% Preference Shares of ₹ 100 each (fully paid-up)

Class A, 8,000 Equity Shares of ? 100 each (₹ 75 paid-up)

Class B, 6,400 Equity Shares of ₹ 100 each (₹ 60 paid-up)

Class C, 56,000 Equity Shares of *X* 10 each (₹ 5 paid-up)

Assets including machinery realized ₹17,50,000. Liquidation expenses including remuneration of liquidator amounted to ₹ 72,000. The company has borrowed a loan of ₹2,00,000 from Bank of Baroda against the mortgage of machinery (which realized ₹ 3,22,000). In the books of the company, salaries of ten clerks for four months at a rate of ₹ 600 per month and salaries of six peons for three months at a rate of ₹ 300 per month, are outstanding. In addition to this, the company's books show other creditors worth ₹5,24,600. Prepare Liquidator's Final Statement of Account. 8

(ii) Relevant balance sheet accounts of Arti Limited, as on 31st March, 2013 and 2014 are as follows: (₹ in lakhs)

Particulars	31.03.13	31.03.14
General Reserve	46	49.50
Profit and Loss A/c (Cr.)	41	47.00
Creditors	25	23.50
Bills Payable	3	4.00

Income Tax Payable	**10**	**17.00**
Proposed Dividend	**15**	**18.00**
Stock	**30**	**27.00**
Debtors	**22**	**26.00**
Bills Receivable	**4**	**2.50**
Prepaid Expenses	**1**	**2.40**

Other Information:

(1) During the year 2013-14, one old machine costing ₹ 6,45,000 (W.D.V. ₹ 3,92,000) was sold for ₹ 3,68,000 and some investments are sold at a profit of ₹ 15,000.

(2) During the year 2013-14, depreciation charged ₹ 4,50,000, goodwill written off ₹25,000 and Income tax paid ₹ 8,75,000.

You are required to calculate the net cash flow from operating activities. 8

Answer: 3 (a) (i)

(1) Computation of Liabilities of Underwriters (No. of Shares)

Particulars	**P**	**Q**	**R**
Gross Liability	12,00,000	12,00,000	12,00,000
Less: Firm Underwriting	1,00,000	1,00,000	1,00,000
	11,00,000	**11,00,000**	**11,00,000**
Less: Marked Application	7,25,000	8,40,000	13,10,000
	3,75,000	**2,60,000**	**(2,10,000)**
Less: Unmarked Application distributed in equal ratio among P & Q	1,12,500	1,12,500	NIL
	2,62,500	**1,47,500**	**(2,10,000)**
Less: Surplus of R distributed to P & Q	1,05,000	1,05,000	2,10,000
Net Liability (excluding firm underwriting)	**1,57,500**	**42,500**	**NIL**
Add: Firm Underwriting	**1,00,000**	**1,00,000**	**1,00,000**
Total Liability (**No. of Shares)**	**2,57,500**	**1,42,500**	**1,00,000**

(2) Computation of amount payable by underwriters

Particulars	**P**	**Q**	**R**
Liability towards shares to be subscribed @ 12 per share	30,90,000	17,10,000	12,00,000
Less: Commission (5% on 12 lakhs @ ₹ 10 each)	6,00,000	6,00,000	6,00,000
Net Amount to be paid by underwriters	**24,90,000**	**11,10,000**	**6,00,000**

(3) In the Books of Massod Ltd.

Journal Entries

Particulars		Dr.	Cr.
Underwriting Commission A/c	Dr.	18,00,000	
To, P Ltd			6,00,000
To, Q Ltd			6,00,000
To, R Ltd			6,00,000
(Being underwriting Commission on the shares underwritten)			
P Ltd	Dr.	30,90,000	
Q Ltd	Dr.	17,10,000	
R Ltd	Dr.	12,00,000	
To, Equity Share Capital A/c			50,00,000
To, Share Premium A/c			10,00,000
(Being shares incl. firm underwritten shares allotted to underwriters)			
Bank A/c	Dr.	42,00,000	
To, P Ltd			24,90,000
To, Q Ltd			11,10,000
To, R Ltd			6,00,000
(Being the amount received towards shares allotted to underwriters, less underwriting commission due to them)			

(3) (a) (ii) Condition for Issue for Sweat Equity Shares

The conditions for Issue of Sweat equity Shares are as follows:

- The issue of Sweat Equity Shares is authorised by a Special Resolution passed by the company in the General meeting.
- The resolution specifies the number of shares, current market piece, consideration if any and the class or classes of directors or employees to whom such equity shared are to be issued.
- Not less than one year has at the date of the issue elapsed since the date on which the company was entitled to commence business.
- The Sweat Equity Shares of a company whose equity shares are listed on a recognised Stock Exchange are issued in accordance with the resolution made by the Securities and Exchange Board of India in this behalf.

Provided that in the case of a company whose equity shares are not listed on any recognized stock exchange, the sweat equity shares are issued in accordance with the guidelines as may be prescribed.

(3) (a) (iii) Let the commission payable to two whole-time directors is x. Then, the remuneration payable to three part-time directors is 1% of ₹ (5000000 - x).

The commission of whole-time directors

= 10% of [₹ 5000000 - 1% of ₹ (5000000-x)]

Thus, x =10% of [₹ 5000000 - 1% of ₹ (5000000-x)]

Or x =10% of [₹ 5000000 - ₹50000 - 0.01x]

Or x = ₹ 495000 + 0.001x

Or x = 495000/0.999 = ₹ 495495

Hence, commission payable to two whole-time directors is ₹495495 and to three part-time directors is 1% of (₹ 5000000 - ₹ 495495) = ₹ 45045.

(3) (b) (i) **1. Computation of purchases consideration etc.**

- Computation of Net Assets available to equity shareholders:

Particulars	Ritu Limited	Richa Limited
	₹ (in lakhs)	₹ (in lakhs)
Fixed Assets (at Book value)	6000	4000
Current Assets	7000	2500
	13000	6500
Less: Liabilities, i.e., Unsecured Loans and Creditors	3000	1500
Net Assets available to Equity Shares	10000	5000

- **Computation of Intrinsic value per Equity Share**

Ritu Limited = ₹ 10000 lakhs/500 lakhs Equity Shares = ₹ 20 per share

Richa Limited = ₹ 5000 lakhs/200 lakhs Equity Shares = ₹ 25 per share

- **Computation of cash payable by Ritu Limited to Richa Limited**

Value of 4 shares of Richa Limited (4 X ₹ 25)

Less: Value of 5 shares of Ritu Limited (5 X ₹ 20)

Balance amount of Richa Limited of 4 shares

- **Computation of Purchase Consideration**

In Equity Shares of Ritu Limited at its Intrinsic value of ₹ 20 per share

2,00,00,000 shares x 5 shares / 4 shares = 2,50,00,000 Shares

Thus, purchase consideration is 2,50,00,000 Equity Shares of ₹10 each in Ritu Limited issued at its intrinsic value of ₹ 20 per share ₹50,00,00,000

2. **Journal of Ritu Limited**

(₹ In lakhs)

1.	Business Purchase A/c	Dr.	5,000	
	To Liquidator of Richa Ltd.'s A/c			5,000
2.	Fixed Assets A/c	Dr.	4,000	
	Current Assets A/c	Dr.	2,500	
	To Unsecured Loan A/c			1,000
	To Creditors A/c			500
	To Business Purchase A/c			5,000
3.	Liquidator of Richa Ltd.'s A/c	Dr.	5,000	
	To Equity share capital A/c			2,500
	To Securities Premium A/c			2,500

(3) (b) (ii) **Books of Mogari Limited**

Journal

(In lakhs)

	Particulars		Dr. (₹)	Cr. (₹)
(i)	Bank A/c	Dr.	28,00,000	
	To E. S. Application A/c			18,00,000
	To Debenture A/c			10,00,000
	(Application money received on 120,000 equity shares @₹15 per share and on 10,000 debentures @ ₹ 10 each)			
(ii)	Bank A/c	Dr.	5,60,000	
	To Profit & Loss A/c			60,000
	To Investment A/c			5,00,000
	(Profit on sale of Investments)			
(iii)	E. S. Application A/c	Dr.	18,00,000	
	To E. S. Capital A/c			12,00,000
	To Securities Premium A/c			6,00,000
	(Application money transferred)			
(iv)	Debenture Application A/c	Dr.	10,00,000	
	To 12% Debenture A/c			10,00,000
(v)	Security Premium A/c	Dr.	7,00,000	
	General Reserve A/c	Dr.	50,000	
	To Premium on redpm. of pref. sh A/c			7,50,000
(vi)	General Reserve A/c	Dr.	12,50,000	
	Profit & Loss A/c	Dr.	5,50,000	
	To Capital Redemption Reserve A/c			18,00,000
(vii)	10% Redeemable P. S. Capital A/c	Dr.	30,00,000	
	Premium on Red. of P. S. A/c	Dr.	7,50,000	
	To Bank A/c			37,50,000

Note: Preference shares are redeemed either out of distributable profits or proceeds from fresh issue of shares or both. Hence, Preference shares of ₹12,00,000 redeemed through fresh issue of equity shares and remaining of ₹18,00,000 redeemed out of profits.

(3) (c) (i) **Liquidator's Final Statement of Account**

	₹		₹
Assets Realised (₹17,50,000 - 3,22,000)	14,28,000	Expenses of Liquidation (including Liquidator's Remuneration)	72,000
		Preferential Creditors	29,400
Surplus from Secured Creditors ₹(3,22,000 - ₹ 2,00,000)	1,22,000	Unsecured Creditors	5,24,600
Proceeds of calls: @ ₹2 per share on 6400 Equity Shares Class 'B'	12,800	Preference Shareholders	9,00,000
@ ₹1.20 per share on 56,000 equity shares of Class 'C'	67,200	Return of ₹13 per share on 8,000 Class TV equity shares	1,04,000
	16,30,000		16,30,000

Nominal Value of Share	62	62	6.2
Net amount per share returnable (+) or receivable	(-) 13	(-) 2	(-) 1.2

(3) (c) (ii)

Calculation of Cash Flow from Operating Activities for the year ended 31st March, 2014

(₹ In Lakhs)

Net Profit before tax and Extra Ordinary Items:	36.75
Adjustment for:	
Transfer to General Reserve	3.50
Loss on sale of old Machine (392000 - 368000)	0.24
Profit on sale of investments	(0.15)
Goodwill written off	0.25
Depreciation	4.50
Operating Profit before working capital changes	45.09
Adjustment for:	
Decrease in Creditors	(1.50)
Increase in Bills Payable	1.00
Decrease in Stock	3.00
Increase in Debtors	(4.00)
Decrease in Bills Receivable	1.50
Increase in Prepaid Expenses	(1.40)
Cash Generated from operations	43.69
Income Tax paid Net	(8.75)
Cash from Operating Activities	34.94

Working Notes:

1. Net Profit before tax and Extra ordinary items:

	(₹ In Lakhs)
P/L A/c as on 31.3.14	47
Less: P/L A/c as on 31.3.13	41
	6
Add: Proposed Dividend	18
Add: Provision for Tax	15.75
N.P. before tax	36.75

2. **Income Tax Payable A/c**

	₹		₹
To Bank	8,75,000	By Balance b/d	10,00,000
To Balance c/d	17,00,000	By P/L A/c	15,75,000
	25,75,000		25,75,000

Statement showing surplus available before notional capital

Particulars	(₹)
Assets realized	14,28,000
(+) Surplus from secured creditors	1,22,000
(-) Expenses of liquidation (including Liquidator's remuneration)	72,000
(-) Preferential Creditors	29,400
(-) Unsecured Creditors	5,24,600
(-) Preference Shareholders	9,00,000
	24,000

Surplus available before notional capital	₹24,000
Add: Notional Capital	
[(8,000×25)+(6,400×40)+(56,000×5)]	₹7,36,000
Total	₹7,60,000

Surplus available for each equivalent number of equity shares of ₹ 10 each

$$= \frac{₹7,60,000}{2,00,000} = ₹3.8$$

Class A Equity Share will receive — [(₹3.8×10)- ₹25] = ₹13.00 per share.
Class B Equity Share will receive — [(₹3.8×10)- ₹40] = (₹2.00) per share.
Class C Equity Share will receive — [₹3.8-₹5] = (₹1.2) per share.

4. Answer *any two* questions: 16x2=32

(a) Comment on the following: 4x4=16

(i) The concept of true and fair is a fundamental concept in Auditing.

(ii) Management Audit is a comprehensive and thorough examination of an organisation or one of its components.

(iii) The Audit Note Book is a permanent record of the auditor.

(iv) The responsibilities of joint auditors are joint and several.

(b) (i) What are the matters to be considered while conducting the audit of a hospital? 8

(ii) State the objectives and functions of the Auditing and Assurance Standard Board (AASB). 4

(iii) Discuss the liability of an auditor towards third parties. 4

(c) (i) As an auditor of a company, how will you verify 'Loose Tools' appearing in the financial statements of the company? 4

(ii) State the Analytical Review Procedure adopted by the auditor of a company to verify inventory. 4

(iii) Explain the standards set for audit of Government Expenditure. 4

(iv) What is meant by Computer Assisted Audit Technique (CAAT)? Name any three CAATs available to the auditor. 4

Answer: 4. (a)

(i) 'The concept of true and fair is a fundamental concept in Auditing".

The phrase "true and fair" in auditor's report signifies that the auditor is required to express his opinion as to whether the state of affairs and the results of the entity as ascertained by him in the course of his audit are truly and fairly represented in the accounts under audit. This requires that the auditor should examine the accounts with a view to verify that all assets, liabilities, income and expenses are stated as amounts which are in accordance with the accounting principles and policies which are relevant and no material amount, item or transaction has been omitted. What constitutes true and fair however has not been defined in any regulation in the context of audit of any company.

Thus what constitutes true and fair is a matter of an auditor's judgement in the particular circumstances of a case, in more specific terms, to ensure true and fair view, an auditor has to see the following, namely:

- That the assets are neither overvalued or under valued according to the applicable accounting principles
- No material asset is omitted
- The charge, if any on assets are disclosed
- Material liability should not be omitted
- 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.
- All unusual exception or non - recurring items have been disclosed separately.

(ii) "Management Audit is a comprehensive and thorough examination of an organisation or one of its components".

Management audit is implemented to identify significant weaknesses in the organisation as corporations, thus providing management with a tool to address and repair the problem area.

The management audit is now widely accepted in the business field for more than 40 years. Corporations and non - profit organisations have utilised the management audit as a comprehensive tool.

The management audit is defined by its scope and objectives. The scope is broad and generally includes all functions of the organisations, including objectives and strategy structure, organisational planning, the budgeting process, human and financial resources management, decision making, research and development, marketing etc.

The audit follows a logical step by step format, including initial interviews with key managers, a study team uses the interview process to define the scope of the audit. Following the stage, the study team then prepares a schedule and detailed plan of study, all aimed at proceeding to the internal fact finding step.

The team generally turns next to an external review, using interviews to determine the opinions and attitudes of the key people outside the organisation have about its operations.

An important aspect of the management audit is the composition of the study team. Both internal and external analysis are frequently used, by an audit team. The composition depends on several factors including the need for independent appraisal.

Management audits are not limited to business corporations, non - profit organisations including educational institutions, hospitals often use the management audit to attempt in improving the operations, when conducted effectively and when recommendations are applied properly, management audit has proved its usefulness as a management technique.

(iii) "The Audit Note Book is a permanent record of the auditor"

An audit note book is a bound book in which a large variety of matters observed during the course of audit are recorded, the audit note book is a permanent record of the auditor for each individual audit. The audit note book should be maintained clearly, completely and systematically. An audit note book is a great evidential tool available at a defence with the auditors in the event of any charge is brought against them.

The various contents of the audit note book are as follows:

- Name of the business enterprise
- Organisation structure
- Important provisions of Memorandum and articles of association
- Communication with the previous auditor, if any
- Management representations and instructions
- List of books of accounts, maintained by the enterprise
- Accounting methods, internal control systems followed by the enterprise, applicable laws, etc.
- Key managerial personnel

- Errors and frauds discovered
- Matters requiring explanations or clarifications
- Special points that need attention in the audit report and for subsequent audits.

(iv) In respect of audit work divided among the joint auditors, each joint auditor is responsible only for the work allocated to him, whether or not he has prepared a separate report on the work performed by him. On the other hand, all the joint auditors are jointly and severally responsible -

(1) in respect of the audit work which is not divided among the joint auditors and is carried out by all of them;

(2) in respect of decisions taken by all the joint auditors concerning the nature, timing or extent of the audit procedures to be performed by any of the joint auditors. It may, however, be clarified that all the joint auditors are responsible only in respect of the appropriateness of the decisions concerning the nature, timing or extent of the audit procedures agreed upon among them; proper execution of these audit procedures is the separate and specific responsibility of the joint auditor concerned;

(3) in respect of matters which are brought to the notice of the joint auditors by any one of them and on which there is an agreement among the joint auditors;

(4) for examining that the financial statements of the entity comply with the disclosure requirements of the relevant statute; and

(5) for ensuring that the audit report complies with the requirements of the relevant statute.

4. (b) (i) AUDIT OF HOSPITAL

The following points are to be considered necessary for conducting an audit of Hospital;

(1) Check the letter of appointment to ascertain the scope of responsibilities.

(2) Study the Charter or Trust Deed under which the hospital has been set up and take a special note of the provisions affecting the accounts.

(3) Examine, evaluate and verify the system of internal check, internal control and determine the nature, timing and the extent of the audit procedures.

(4) Vouch the entries in the Patient's Bill Register with a copies of bill issued. Test check the selected bills to see that these have been correctly prepared taking into consideration the period of stay of each patient as recorded in the Attendance Schedule.

(5) Vouch the collection from patients with copies of bills and entries in Bills Register. Arrears of dues should be properly carried forward and where these are deemed to be irrecoverable, they should be written off under due authorizations.

(6) Interest and/ or dividend income should be vouched with reference to the Investment Register and Interest and Dividend warrants.

(7) In case of legacies and donations which are received for specific purposes, it should be ensured that any income there from is not utilized for any other purposes.

(8) Where receipts of subscription show a significant deviations from budgeted figures, it should be thoroughly inquired into and the matter be brought to the notice of the trustees or the Managing Committee.

(9) Government grants or grants from local bodies should be verified with the reference to the correspondence with the concerned authorities.

(10) Clear distinction should be made between the items of capital and revenue nature.

(11) The capital expenditure should be incurred under proper authorization by a valid resolution of the trustees or the Managing Committee.

(12) Verify the system of internal check as regards purchases and issue of stores, medicines etc.

(13) Examine that the appointment of the staff, payment of salaries etc. are duly authorized.

(14) Physically verify the investments, fixed assets and inventories.

(15) Check that adequate depreciation has been provided on all the depreciable assets.

4. (b) (ii) The objectives and functions of the Auditing and Assurance Standard Board are as follows:

(1) To review the existing and emerging auditing practices worldwide.

(2) To formulate Engagement Standards, Standards on Quality Control and Statement on Auditing.

(3) To review and revise the existing Standards and Statements on Auditing.

(4) To develop Guidance Notes on issues arising out of any Standard, auditing issues pertaining to any specific industry and revise.

(5) To review and revise the existing Guidance Notes.

(6) To formulate General Clarifications, where necessary, on issues arising from Standards.

(7) To formulate and issue Technical Guides, Practice Manuals, Studies and other papers.

4. (b) (iii) Liabilities to third party:

The following points are the liabilities of an auditor towards Third party :

Generally, it appears that as there is no privacy of contract between auditor & third party, he cannot be held liable and as he is never appointed by third party he has nothing to do with such a party & this was confirmed by the case of Le Lievre & Dennes VS Gould 1893.

No doubt/there is no privacy of contract, the third party can hold the auditor liable for any fraud. Auditor has moral responsibility to third party.

If anybody relying on the audited statement of a company, takes any decision & suffers any loss because such statements were false, the auditor will be responsible to them.

If auditor had authorized the issue of a prospectus containing misleading statements, he would be held liable for damages to third party, which has purchased the shares of the company on the strength of such a misleading statement, even though there might not have been any privacy of contract between the auditor & the shareholder.

4. (c) (i) Loose Tools:

Loose tools at the end of the year should be checked by the auditor as follows:

(i) The auditor should see that the cost of loose tools is properly determined and certified by the Chief Engineer.

(ii) If the loose tools are manufactured by the organization, the authorized officer shall certify the value of such tools.

(iii) He should physically verify these tools or obtain a list of tools duly certified by the responsible officer. Any discrepancies shall be investigated.

(iv) Ensure that the closing stock of tools is valued at cost. See that the valuation is done on the basis, which is consistent taking in to consideration obsolescence, damage, brokerage etc.,

(v) See that the loose tools are disclosed in the Balance Sheet on asset side under the head "Current Assets".

4. (c) (ii) Analytical Review Procedures for Verification of Inventories:

The auditor can adopt the following analytical review procedures to verify the inventory.

(i) Quantitative reconciliation of opening inventories, purchases, production, sales and closing inventories;

(ii) Comparison of closing inventory quantities and amounts with those of the previous year.

(iii) Comparison of the inventory turnover ratios for the current year with that of the previous year and with industry standards if available.

(iv) Comparison of the closing inventory (Raw materials, closing work-in-progress and finished goods are percentage of total inventories) with the corresponding figures of the previous year.

(v) Comparison of current year gross profit ratio of the previous year.

(vi) Comparison of actual inventory, purchase and sales figures with the budgeted figures if available.

(vii) Comparison of raw-material yield/wastage with previous year figures

4. (c) (iii) Government Expenditure Audit:

Audit of government expenditure is one of the major components of government audit conducted by the office of C & AG. The basic standards set for audit of expenditure are to ensure that there is provision of funds authorised by competent authority fixing the limits within which expenditure can be incurred. Briefly, these standards are explained below:

(i) **Audit against Rules & Orders:** The auditor has to see that the expenditure incurred conforms to the relevant provisions of the statutory enactment and is in accordance with the financial rules and regulations framed by the competent authority.

(ii) **Audit of Sanctions:** The auditor has to ensure that each item of expenditure is covered by a sanction, either general or special, accorded by the competent authority, authorising such expenditure.

(iii) **Audit against Provision of Funds:** It contemplates that there is a provision of funds out of which expenditure can be incurred and the amount of such expenditure does not exceed the appropriations made.

(iv) **Propriety Audit:** It is required to be seen that the expenditure is incurred with due regard to broad and general principles of financial propriety. The auditor aims to bring out cases of improper, avoidable, or in fructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations. Audit aims to secure a reasonably high standard of public financial morality by looking into the wisdom, faithfulness and economy of transactions.

(v) **Performance Audit:** This involves that the various programmes, schemes and projects where large financial expenditure has been incurred are being run economically and are yielding results expected of them. Efficiency-cum- performance audit, wherever used, is an objective examination of the financial and operational performance of an organisation, programme, authority or function and is oriented towards identifying opportunities for greater economy, and effectiveness.

4. (c) (iv) computer Assisted Audit Technique (CAAT)

Computer assisted audit technique uses computer to process the information, required for audit, stored in the auditee's information system. This technique is used for testing general controls and application controls and also for substantive procedures. This technique is also helpful in getting data from auditee's record as well as for analytical procedures.

The auditor must have expertise and experience in executing and using the results of the Computer Assisted Audit Technique. Before applying this technique auditor should get reasonable assurance of its integrity, reliability, usefulness and security through appropriate planning, designing, processing and review of documentation. He should see that this technique is properly controlled. Auditor should maintain sufficient documents describing the application of the technique and regarding planning, execution, inputs, processing, output, source code, technical information about the auditee's accounting system, audit evidence and suggestions, if any, for use of the technique in future etc. Auditor should make necessary arrangements for data files to minimize the effect on auditee's routine activities.

Different Computer Assisted Audit Techniques available are as under.

(a) Test data

(b) Integrated Test Facility

(c) Audit Software

(d) Audit Automation

(e) Core Image Comparison

(f) Data Base Analysis

(g) Embedded Code

(h) Log Analyzers

(i) Mapping

(j) Modeling

(k) Online Testing

(l) Program Code Analysis

(m) Program Library Analyzers

(n) Snapshots

(o) Source Comparison

(p) Tracing