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The Company Audit

Question 1

In the Notes to Accounts of Z Co. Ltd. as on 31-03-2014 Note no. 10 states that certain machinery items are lying at customs warehouses and that the Company has paid ₹ 500 lakhs up to 30-06-2013 as detention charges, out of which a sum of ₹ 220 lakhs is written back during the year 2013-14 based on settlement with the concerned authorities in respect of a major spares of machinery. For the remaining machinery items, negotiations are pending and a provision of ₹ 48 lakhs has been made. As such a total amount of ₹ 328 lakhs paid/provided on account of detention charges have been capitalized and included in the Fixed Assets/Capital work in progress. The Management is of the view that these expenses are directly attributable to the acquisition of the related Fixed Assets. As the auditor how would you respond to this? (5 Marks, November, 2014)

Answer

Capitalization of Detention Charges for Fixed Assets Lying at Custom Warehouses: As per AS 10 "Accounting for Fixed Assets", the cost of an item of fixed asset comprise its purchase price, including import duties and other non-refundable taxes or levies and any directly attributable cost of bringing the asset to its working condition for its intended use.

Generally, detention charges represent an abnormal expenditure, as these expenditures are not directly attributable to the cost of asset.

In the case of Z Co. Ltd., the auditor will qualify the report appropriately in the paragraph before stating that the Balance Sheet gives true and fair view and the Statement of Profit and Loss shows true and fair profit of the year ending on 31-3-2014. The qualification will be as follows:

"Attention is invited to Note no. 10 regarding Capitalization of detention charges of ₹ 328 lakhs during the year and on account of delays in respect of clearing from custom warehouses for certain machinery items. In our opinion the detention charges are not directly attributable to the acquisition of related fixed assets. The said amount of ₹ 328 lakhs should have been written off in the Statement of Profit and Loss. Had these expenses been so written off, the profits for the year would have been lower by ₹ 328 lakhs and Reserves & Surplus as well as Fixed Assets/Capital WIP would have been lower by ₹ 328 lakhs."

Question 2

Comment on the following:

(a) A Ltd. is a Chennai based company. The total turnover of the company is ₹ 10 crores for the year 2012-13. The company has a branch office at an area which was recently affected by flood. The transportation services are not available due to destruction caused by flood. The branch office recorded turnover of ₹ 1,50,000 in the Financial Year 2012-13. No audit of branch has been carried out. The statutory auditor of the company has made no reference of the above branch in his report. (4 Marks, May, 2014)

(b) For the year ended on 31st March, 2014, P Ltd. proposed to pay a dividend of 25% on its equity shares and it further proposed to transfer 20% of Net profit for that year after tax to its reserves. Its auditor objected to the same stating that 10% is the maximum permissible limit to transfer to reserves. (4 Marks, May, 2014)

Answer

(a) Branch Audit: As per section 143(8) of the Companies Act, 2013, if a company has a branch office, the accounts of that office shall be audited either by the auditor appointed for the company under this Act or by any other person qualified for appointment as an auditor of the company under this Act and appointed as such under section 139, or where the branch office is situated in a country outside India, the accounts of the branch office shall be audited either by the company's auditor or by an accountant or by any other person duly qualified to act as an auditor of the accounts of the branch office in accordance with the laws of that country.

In the given situation, A Ltd. is a Chennai based company, having total turnover of ₹ 10 Crore. The company is having a branch office at an area which is recently affected by flood.

Therefore, the company has to get its branch audited. In case no branch audit has been carried out, company's auditor is required to mention this fact in the audit report and deal appropriately. Thus, no reference of above branch in statutory auditor's report is not correct.

(b) Transfer to Reserve: Section 123(1) of the Companies Act, 2013 provides that dividend cannot be declared or paid by a company for any financial year except out of profits of the company for that year arrived at after providing for depreciation in accordance with the provisions of Section 123(2), or out of the profits or the company for any previous financial year or years arrived at after providing for depreciation in the manner aforementioned and remaining undistributed, or out of both.

However, the first proviso to section 123(1) of the said Act provides that a company may, before the declaration of any dividend in any financial year, transfer such percentage of its profit for that financial year as it may consider appropriate to the reserves of the company irrespective of the size of the declared dividend i.e. the company is not mandatorily required to transfer the profit to the reserves, it is an option available to the company to transfer such percentage.

In the instant case, P Ltd. has proposed to pay a dividend of 25% on its equity shares and it further proposed to transfer 20% of Net profit for that year after tax to its reserves.

Therefore, from the above facts and provisions, it may be concluded that P Ltd. is under no violation of law i.e. the company is free to transfer any amount of its profit to the reserves, without any compulsion or restriction, before declaration of any dividend.

Question 3

X Limited, a newly incorporated company in India commenced its business from April 1, 2012. The Company purchased fixed assets costing ₹ 4,000 lakhs on 01-04-2012 and the same was fully financed by foreign currency loan (U.S. Dollars) payable in three annual equal installments. Exchange rates were 1 Dollar = ₹ 40.00 and ₹ 42.50 as on 01-04-2012 and 31-03-2013 respectively. The company worked out foreign exchange loss as per AS 11 at ₹ 250 Lakhs and expensed the entire amount in the profit and loss account. The Managing Director of the company was worried about this heavy revenue loss and asked the accountant not to follow AS 11 issued by the ICAI for this particular transaction. The Accountant of the company, followed the instruction of the Managing Director and removed exchange loss from the profit and loss account but then he added the entire exchange loss to the value of fixed asset and computed the depreciation thereon. As an Auditor of X Limited how you would deal with this particular transaction? (5 Marks, November, 2013)

Answer

Treatment of Changes in Foreign Exchange Rates: As per Para 46A(1) of AS 11 "The Effects of Changes in Foreign Exchange Rates'' inserted by Ministry of Corporate Affairs by way of notification, the exchange differences arising on reporting of long- term foreign currency monetary items in so far as they relate to the acquisition of a depreciable capital asset, in respect of accounting periods commencing on or after the 1st April, 2011, can be added to or deducted from the cost of the asset and shall be depreciated over the balance life of the asset, and in other cases, it can be accumulated in a ''Foreign Currency Monetary Item Translation Difference Account" in the enterprise's financial statements and amortized over the balance period of such long term asset or liability, by recognition as income or expense in each of such periods.

Thus, X Ltd. has the choice to avail this option. However, the company should disclose the fact of such option and of the amount remaining to be amortized in the financial statements of the period in which such option is exercised and in every subsequent period so long as any exchange difference remains unamortized.

Question 4

Excellent Limited, a Company incorporated in India and listed with SEBI, has a scheme for payment of settlement allowance to retiring employees. Under the scheme, retiring employees are entitled to reimbursement of certain travel expenses for class they are entitled to as per company rules and regulations. Employees are also entitled to claim a lump-sum payment to cover expenses on food and stay during the travel. The Company also gives option to employees that they can claim a lump-sum amount equal to three months pay last drawn.

Excellent Limited have following accounting policies to record these travel expenses:

(i) Settlement allowance does not depend upon the length of service of employee. It is restricted to employee's eligibility under the travel rule of the company therefore all travel expenses fall under the category of defined contribution plans.

(ii) Since it is not related to the length of service of the employees, it is difficult to estimate reliably and there is no present obligation to pay employees as per AS 29 "Provisions, Contingent Liabilities and Contingent Assets", hence it is accounted for on claim basis.

You are statutory auditor of Excellent Limited. What would be your guidance to audit team?

(4 Marks, November, 2013)

Answer

Treatment of Employee Benefits Expenses: The present case falls under the category of defined benefit scheme under AS 15 "Employee Benefits". The said scheme encompasses cases where payment promised to be made to an employee at or near retirement presents significant difficulties in the determination of periodic charge to the statement of profit and loss. The contention of the Company that the settlement allowance will be accounted for on claim basis is not correct even if company's obligation under the scheme is uncertain and requires estimation. In estimating the obligation, assumptions may need to be made regarding future conditions and events, which are largely outside the company's control. Thus,

(i) Settlement allowance payable by the company is a defined retirement benefit, covered by AS 15.

(ii) A provision should be made every year in the accounts for the accruing liability on account of settlement allowance. The amount of provision should be calculated according to actuarial valuation.

(iii) Where, however, the amount of provision so determined is not material, the company can follow some other method of accounting for settlement allowances.

Question 5

X Ltd is engaged in the business of newspaper and radio broadcasting. It operates through different brand names. During FY 12-13 it incurred substantial amounts on external trade, business communication and branding expenses by participation in various corporate social responsibility initiatives. The company expects to benefits by this expenditure by attracting new customers over a period of time and accordingly it has capitalized the same under brand development expenses and intends to amortize the same over the period in which it expects the benefits to flow. As the statutory auditor of the company do you concur? Give reasons.

(4 Marks, November, 2013)

Answer

As per AS-26 on "Intangible Assets", expenditure on an intangible item should be recognised as an expense when it is incurred unless it forms part of the cost of an intangible asset that meets the recognition criteria.

In the given case, it incurred substantial amounts on external trade, business communication and branding expenses by participation in various corporate social responsibility initiatives. The company expects to benefits by this expenditure by attracting new customers over a period of time and accordingly it has capitalized the same under brand development expenses. Here, no intangible assets or other asset is acquired or created that can be recognized.

Therefore the accounting treatment by the company to amortize the entire expenditure over the period in which it expects the benefits to flow is not correct and the same should be debited to the Statement of Profit and Loss in the year of incurring.

Question 6

(a) *The Balance Sheet of G Ltd as at 31st March 13 is as under. Comment on the presentation in terms of revised Schedule VI and Accounting Standards issued by NACAS.*

Heading	*Note No.*	*31st March, 13*	*31st March, 12*
Equity & Liabilities			
Share Capital	*1*	*XXX*	*XXX*
Reserves & Surplus	*2*	*0*	*0*
Employee stock option outstanding	*3*	*XXX*	*XXX*
Share application money refundable	*4*	*XXX*	*XXX*
Non-Current Liabilities		*XXX*	*XXX*
Deferred tax liability (Arising from Indian Income Tax)	*5*	*XXX*	*XXX*
Current Liabilities			
Trade Payables	*6*	*XXX*	*XXX*
Total		*XXXX*	*XXXX*
Assets			
Non-Current Assets			
Fixed Assets-Tangible	*7*	*XXX*	*XXX*
CWIP (including capital advances)	*8*	*XXX*	*XXX*
Current Assets			
Trade Receivables	*9*	*XXX*	*XXX*
Deferred Tax Asset (Arising from Indian Income Tax)	*10*	*XXX*	*XXX*
P & l Debit balance		*XXX*	*XXX*
Total		*XXXX*	*XXXX*

(b) Z Ltd changed its employee remuneration policy from 1st of April 2012 to S provide for 12% contribution to provident fund on leave encashment also. As per the leave encashment policy the employees can either utilize or encash it. As at 31st March 13 the company obtained an actuarial valuation for leave encashment liability. However it did not provide for 12% PF contribution on it. The auditor of the company wants it to be provided but the management replied that as and when the employees availed leave encashment, the provident fund contribution was made. The company further contends that this is the correct treatment as it is not sure whether the employees will avail leave encashment or utilize it. Comment.

(c) T. Ltd. commenced its manufacturing activities from 1st April, 2012. In the course of production the company generated certain by-products. As at 31st March 13 the company did not value the by-products considering the value as insignificant. The auditor of the company is of the opinion that the by-products are inventory of the company and it should be valued and brought into books of account. Comment.

(d) K Ltd. had 5 subsidiaries as at 31st March 2013 and the investments in-subsidiaries are considered as long term and valued at cost. Two of the subsidiaries net worth eroded as at 31st March 13 and the prospects of their recovery are very bleak and the other three subsidiaries are doing exceptionally well. The company did not provide for the decline in the value of investments in two subsidiaries because the overall investment portfolio in subsidiaries did not suffer any decline' as the other three subsidiaries are doing exceptionally well. Comment. (5 Marks each, May, 2013)

Answer

(a) This question is redundant in view of the provisions of the Companies Act, 2013.

(b) As per Para 11 of AS-15 on "Employee Benefits", issued by the Institute of Chartered Accountants of India, an enterprise should recognize the expected cost of short-term employee benefits in the form of compensated absences in the case of accumulating compensated absences, when the employees render service that increases their entitlement to future compensated absences.

Since the company obtained actuarial valuation for leave encashment, it is obvious that the compensated absences are accumulating in nature. An enterprise should measure the expected cost of accumulating compensated absences as the additional amount that the enterprise expects to pay as a result of the unused entitlement that has accumulated at the balance sheet date.

Here, Z Ltd will accumulate the amount of leave encashment benefits as it is the liability of the company to provide 12% PF on amount of leave encashment. Hence the contention of the auditor is correct that full provision should be provided by the company.

(c) As per AS-2 on "Valuation of Inventories", issued by the Institute of Chartered Accountants of India, a production process may result in more than one product being produced simultaneously. This is the case when joint products are produced or when there is a main product & by-products. If the costs of conversion of each product are not separable, they are allocated on a rational & consistent basis.

Most of the by-products as well as scrap or waste materials, by their nature, are immaterial. They are often measured at net realizable value & this value is deducted from the cost of the main product. In the given case, as the value of the by-products is insignificant, the realizable value of by products should be ascertained and it should be deducted from the cost of the main product.

An asset is a resource controlled by an enterprise as a result of past events from which the future economic benefits are expected. As per AS 2, inventories are assets (a) held for sale in the ordinary course of business (b) in the process of production for such sale (c) in the form of materials or supplies to be consumed in the production process or in the rendering of services. As the stock of by-product is a resource controlled by T Ltd., it is an asset and it is inventory because it is held for sale in the ordinary course of business.

Hence, T Ltd. should deduct the realizable value of its by-products from the cost of production of main product.

(d) As per AS-13 "Accounting for Investments" issued by the Institute of Chartered Accountants of India, long-term investments are usually of individual importance to the investing enterprise. The carrying amount of long-term investments is therefore determined on an individual investment basis. Investments classified as long term investments should be carried in the financial statements at cost. However, provision for diminution shall be made to recognize a decline, other than temporary, in the value of the investments, such reduction being determined and made for each investment individually.

Keeping in view the above, K Ltd should provide for the decline in the value of investments in two subsidiaries despite the fact that the overall investment portfolio in subsidiaries did not suffer any decline.

Question 7

As a statutory auditor of a company, comment on the following:

(a) For the year ended 31st March, 2012, the financial statements of A Pvt. Ltd. were adopted on 31st July, 2012. At this meeting, the directors proposed a dividend for the year 2011-12 of 25% on the equity share capital amounting to ₹ 10 lakhs. No entry was passed for the proposed dividend in the books of the company, since in the view of the directors the same was not required as per Revised Schedule VI.

(b) The accounting policy on Revenue Recognition for a company engaged in manufacture and sale of chemical products was stated as "Revenue is recognized only when it can be reliably measured and it is reasonable to expect ultimate collection".

(5 Marks each, November, 2012)

Answer

(a) This question is redundant in view of the provisions of the Companies Act, 2013.

(b) Revenue Recognition: As per AS 9 Revenue Recognition, in a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions have been fulfilled:

(i) the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and

(ii) no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods.

Therefore, revenue from sales transactions should be recognised when the requirements as to performance set out above is satisfied, provided that at the time of performance it is not unreasonable to expect ultimate collection. If at the time of raising of any claim uncertainty regarding collection exist, then revenue recognition should be postponed.

In the instant case, the company is engaged in manufacturing and sale of chemical products, and made disclosure in accounting policy on recognition of revenue as per AS 1 stating that revenue is recognized only when it can be reliably measured and it is reasonable to expect ultimate collection, is correct. However, accounting policy disclosed above should also cover the aspect of transfer of risk and reward for the purpose of revenue recognition.

Question 8

Comment "M/s. PQR has been appointed the sole statutory auditor of a large company for 2011-12, where till last year M/s. LMN was also one of the joint auditors along with M/s. PQR. Mention the steps that should be taken by M/s. PQR before commencing the audit".

(8 Marks, November, 2012)

Answer

Steps Before Commencing the Audit Work: When one of the joint auditors of the previous year is considered for ratification by the members as the sole auditor for the next year, it is similar to non re-appointment of one of the retiring joint auditors. The provisions of section 140 of the Companies Act, 2013 (hereinafter referred as the Act) relating to non-reappointment of the retiring auditor need to be considered. As per sub-section 4 of section 140 of the Act, special notice shall be required for a resolution at an annual general meeting appointing as auditor a person other than a retiring auditor, or providing expressly that a retiring auditor shall not be re-appointed, except where the retiring auditor has completed a consecutive tenure of five years or, as the case may be, ten years, as provided under sub-section (2) of section 139 of the Act.

The following steps should be taken care of by M/s. PQR before commencing the audit:

(i) Ascertain that special notice under Section 140(4) of the Act was duly received by the company, from such number of members holding not less than one percent of total voting power or holding shares on which an aggregate sum of not less than five lakh rupees has been paid up on the date of the notice, not earlier than three months but at least 14 days before the AGM date as per Section 115 of the Act read with rule 23(1) and 23(2) of the Companies (Management and Administration) Rules, 2014.

(ii) Check whether the said notice has been sent to all the members at least 7 days before the date of the AGM as per Section 115 of the Act read with rule 23(3) of the Companies (Management and Administration) Rules, 2014.

(iii) Verify the notice contains an express intention of a member for proposing the resolution for appointing a sole auditor in place of both the joint auditors who retire at the meeting but are eligible for re-appointment.

(iv) Verify that the said notice is also sent to the retiring auditor as per Section 140(4)(ii) of the Act.

(v) Verify whether any representation received from the retiring auditor was sent to the members of the company to whom notice of the meeting was sent as per Section 140(4)(iii) of the Act.

(vi) Verify from the minutes book whether the representation received from the retiring joint auditor was considered at the AGM.

(vii) Examine that proposed resolution was properly passed.

Further, Clause (8) of Part I of the First Schedule to the Chartered Accountants Act, 1949, provides that a member in practice shall be deemed to be guilty of professional misconduct if he accepts a position as auditor previously held by another chartered accountant without first communicating with him in writing. Moreover, Clause (9) of Part I of the same Schedule, provides that a member in practice shall be deemed to be guilty of professional misconduct if he accepts an appointment as auditor of a company without first ascertaining from it whether the requirements of Sections 224 and 225 of the Companies Act, 1956 (now Section 139 and 140 read with section 141 of the Companies Act, 2013), in respect of such appointment have been duly complied with.

Therefore, M/s PQR is required to comply with all the above mentioned provisions provided under Companies Act and Chartered Accountant Act before commencing the audit.

Question 9

A Ltd is a manufacturer of readymade garments. It sells its products to franchisees located across the country. Readymade garment industry is subject to change in trends of fashion and as such, some of the goods are returned and A Ltd accepts them back as sales returns. On the basis of past trends such returns are estimated to be at 20% of the sales of any year. For the financial year 2011-12, A Ltd had accounted for the actual sales return made upto 31st March 2012 but has not reversed the possible expected return that are likely to happen after 31st March 2012, in respect of the sale made for the FY 11-12. Mr. X the auditor of A Ltd wants this to be considered in the accounts for the year ended on 31st March 2012 but the company is of the opinion that although there is a probability of some goods being returned by the franchisees, there is no significant uncertainty regarding the amount of consideration that will be derived from the sale of goods, since the goods are not in the possession of the company and risk and rewards of ownership still lie with the franchisees and the company cannot record sales returns in its books of account in respect of goods that are likely to be received after the date of balance sheet. Comment. (5 Marks, May, 2012)

Answer

Recognition of Revenue: AS 9 on 'Revenue Recognition', states that revenue from sale of goods should be recognised when the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership and no significant uncertainty exists regarding the amount of consideration.

Further, revenue recognition is mainly concerned with the timing of recognition of revenue in statement of profit and loss of an enterprise. The amount of revenue arising on a transaction is usually determined by the agreement between the parties involved in the transaction. When uncertainties exist regarding the determination of the amount, or its associated costs, these uncertainties may influence the timing of revenue recognition.

In the present case, A Ltd. is a manufacturer of readymade garments and sells its products to franchisees located across the country. Due to change in trends of fashion etc sold goods are being returned and A Ltd. accepts them back as sales returns. On the basis of past trends such returns are estimated as 20% of the sales of any year.

In this case, the company is bearing the risk of sales return and therefore, the company should not recognize the revenue to the extent of 20% of its sales. The company may disclose suitable revenue recognition policy in its financial statements separately.

In the absence of the above, the auditor must qualify his report.

Note: Alternative Answer is possible on the basis of AS 29 on Provisions, Contingent Liabilities and Contingent Assets by recognising the whole sales as revenue, i.e., 100% accounted in Statement of Profit and Loss as sales Income as there is no significant uncertainty regarding the amount of consideration. However, keeping in view its past performance, A Ltd. should make a provision for sales income which is not likely to realise. In the absence of the above, the auditor will have to qualify his report.

Question 10

Comment on the following:

(a) MRE Ltd. provided ₹ 25 lakhs for Inventory obsolence in 2009-10. In the subsequent years, it was determined that 50% of such stock was usable. The Board of Directors wants to adjust the same through prior period adjustment. (5 Marks, November, 2011)

(b) SRS Ltd. has drawn the financial statement as on 31-3-11 and presented to you alongwith additional information:

Balance Sheet of SRS Ltd. as on 31-3-11

Liabilities	*Amt.*	*Assets*	*Amt.*
Share capital	*50,00,000*	*Fixed Assets*	
Reserves & Surplus		*Gross block*	
Profit and Loss Alc	*4,00,000*	*Less: Depreciation*	*1,00,00,000*

Secured Loans	*75,00,000*	*Investments*	*Nil*
Current Liabilities and Provisions		*Current Assets Loans & Advances*	
Creditors for trade	*3,00,000*	*Debtors*	*25,00,000*
Advance received	*3,00,000*	*Advance Paid*	*10,00,000*
	1,35,00,000		*1,35,00,000*

Additional Information:

(a) Entire pre-operative expenses of ₹ 7,00,000/- was charged to Profit and Loss Account whereas for the purpose of Income Tax, only what is allowable is claimed.

(b) Depreciation as per Books - ₹ 35,00,000/-

Depreciation as per Income tax - ₹ 50,00,000/-

(c) Losses to be carried forward as per Income Tax Act - ₹ 16,00,000/-

(d) Donation disallowed while computing tax - ₹ 50,000/-

Considering the additional information, can you certify that the company has complied with the Accounting Standards and issue an unqualified report? (6 Marks, November, 2011)

(c) ABC & Co. and DEF & Co, Chartered Accountant firms were appointed as joint auditors of Good Health Care Ltd. for 2009-10. A special audit was conducted U/s 233A of the Companies Act 1956 during March 2011 and observed gross understatement of Revenue. The revenue aspects were looked after by DEF & Co, but there was no documentation for the division of work between the joint auditors. (4 Marks, November, 2011)

Answer

(a) Prior Period Adjustment: As per AS 5 on "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies", prior period items are income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods. The write-back of provision made in respect of inventories in the earlier year does not constitute prior period adjustment since it neither constitutes error nor omission but it merely involves making estimates based on prevailing circumstances when financial statements were being prepared. It is a mere estimate process involving judgement based on the latest information available.

An estimate may have to be revised if changes occur regarding the circumstances on which the estimate was based, or as a result of new information, more experience or subsequent developments. The revision of the estimate, by its nature, does not bring the adjustment within the definitions of an extraordinary item or a prior period item.

A change in an accounting estimate may affect the current period only or both the current period and future periods. In both cases, the effect of the change relating to the current period is recognised as income or expense in the current period. The effect, if any, on future periods, is recognised in future periods.

Further, as per SA 540 "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures", the auditor shall review the outcome of accounting estimates included in the prior period financial statements or where applicable, their subsequent re-estimation for the purpose of the current period.

In this case, MRE Ltd. provided ₹ 25 lakhs for inventory obsolescence in 2009-10. In the subsequent year due to change in circumstances, it was determined that 50% of such stock was usable. Revision of such an estimate does not bring the resulting amount of ₹ 12.5 lakhs within the definition either of a prior period item or of an extraordinary item. The amount, however, involved is material and requires separate disclosure to understand the financial position and performance of an enterprise. Accordingly, adjustment in the value of the inventory through prior period item would not be proper.

(b) Compliance with the Accounting Standards: As per AS 26 "Intangible Assets", when an expenditure is incurred to provide future economic benefits to an enterprise, but no intangible asset or other asset is acquired or created that can be recognised, then such an expenditure is recognised as an expense when it is incurred. Therefore, expenditures for commencing new operations or launching new products or processes (pre-operating costs) should be expensed off in the year of incurrence as no asset is created.

Further, as per AS 22 "Accounting for Taxes on Income", tax expense for the period, comprising current tax and deferred tax, should be included in the determination of the net profit or loss for the period. It may also be noted that Deferred Tax is the tax effect of timing difference. Hence deferred tax should be recognised for all the timing differences, however, permanent differences do not result in deferred tax assets or deferred tax liabilities. Thus, Tax Expense = Current Tax + Deferred Tax.

Point no. (a) of additional information is in compliance with AS 26, hence no qualification is required in view of AS 26. But at the same time it leads to timing difference which will require the creation of DTA/ DTL as per AS 22. (DTA- Deferred Tax Assets, DTL-Deferred Tax Liabilities)

Similarly, point no. (b) and (c) of additional information are also the case of timing differences which creates DTA/ DTL as per AS 22.

Creation of DTA / DTL on account of such timing differences needs to be reported in the Financial Statements.

However, point no. (d) is a situation of permanent difference as per AS 22. Hence no DTA/DTL is required to be accounted for.

A prima facie look to the given balance sheet states that no tax expense has been provided for. Accordingly, qualification in audit report is required in view of non compliance of AS 22.

Further, presentations of Fixed Assets are also not in compliance with disclosure requirement of AS 6 and AS 10. Therefore, as an auditor, we cannot certify that the company has complied with all the Accounting Standards.

(c) Documentation for Division of Work between the Joint Auditors: As per SA 299 "Responsibility of Joint Auditors", where joint auditors are appointed, they should, by mutual discussion, divide the audit work among themselves. The division of work would usually be in terms of audit of identifiable units or specified areas.

In some cases, due to the nature of the business of the entity under audit, such a division of work may not be possible. In such situations, the division of work may be with reference to items of assets or liabilities or income or expenditure or with reference to periods of time. Certain areas of work, owing to their importance or owing to the nature of the work involved, would not be divided and would be covered by all the joint auditors.

The division of work among joint auditors as well as the areas of work to be covered by all of them should be adequately documented and preferably communicated to the entity.

Further, each joint auditor is entitled to assume that the other joint auditors have carried out their part of the audit work in accordance with the generally accepted audit procedures. It is not necessary for a joint auditor to review the work performed by other joint auditors or perform any tests in order to ascertain whether the work has actually been performed in such a manner. Each joint auditor is entitled to rely upon the other joint auditors for bringing to his notice any departure from generally accepted accounting principles or any material error noticed in the course of the audit.

In the present case, there was no documentation for the division of work and the responsibility of revenue aspect was delegated to DEF & Co., in which gross understatement of revenue has been observed. ABC & Co. has not reviewed the work as they have put their reliance on the work performed by DEF & Co.

Hence, there is a violation of SA 299 as the division of work has not been documented. In the normal course DEF & Co. will be held liable for negligence. If DEF & Co. refuses to accept sole responsibility for the fault, ABC & Co. have to prove by other ways and means of evidences that the particular area of audit was exclusively done by DEF & Co. only.

Question 11

A infrastructure company has constructed a mall and entered into agreement with tenants towards license fees (monthly rental) and variable license fees, a percentage on the turnover of the tenant (on an annual basis). Chief Finance Officer wants to account/recognize license fee as income for 12 months during current year under audit and variable license fees as income during next year, since invoice is raised in the subsequent year. As an auditor, how would you deal and state in the statement of Accounting policies? (6 Marks, November, 2011)

Answer

Revenue Recognition: AS 9 on Revenue Recognition, is mainly concerned with the timing of recognition of revenue in the statement of profit and loss of an enterprise. The amount of revenue arising on a transaction is usually determined by agreement between the parties involved in the transaction. However, when uncertainties exist regarding the determination of

the amount, or its associated costs, these uncertainties may influence the timing of revenue recognition.

Further, as per accrual concept of fundamental accounting assumptions given in AS 1 "Disclosure of Accounting Policies", revenue should be recognised as and when it is accrued i.e. recorded in the financial statements of the periods to which they relate.

In the present case, monthly rental towards licence fees and variable licence fees as a percentage on the turnover of the tenant though on annual basis is the income related to common financial year. Therefore, recognising the fees as revenue cannot be deferred simply because the invoice is raised in subsequent period. Hence it should be recognised in the financial year of accrual.

Therefore, the contention of the Chief Financial Officer is not in accordance with AS 9 and hence the auditor may qualify the report indicating the understatement of income/profit and that the Statement of Profit and Loss does not exhibit a true and fair view of the profit or loss.

Question 12

(a) In the course of audit of T Ltd. you observed that export incentives are not accounted on accrual basis. The company's management contended that these would be accounted on cash basis citing the uncertainty about its receipts as they are not admitted as due by the customs authorities. Comment. *(4 Marks, May, 2011)*

(b) Z Ltd. has flexi deposit linked current account with various banks. Cheques are issued from the current account and as per the requirements of funds, the flexi deposits are encashed and transferred to current accounts. As of 31st March, 2011 certain cheques issued to vendors are not presented for payment resulting in the credit balance in the books of the company. The management wants to present the book overdraft under current liabilities and flexi deposits under cash & bank balances. Comment.

(8 Marks, May, 2011)

Answer

(a) Accountability of Export Incentives: The exporters receive certain incentives (monetary or non-monetary) from the Government of India on export of goods. However due to various procedural delays and laws involved which keep changing frequently, there is generally a delay in actual receipt of the export incentives. Further the receipt of the export incentives may not be assured in certain situations due to frequent changes in the policies of the Government. In such cases, it may be reasonable to presume that the receipt of the incentives is uncertain till the time they are actually received.

As per AS 9 "Revenue Recognition", if at the time of raising the claim for incentive, it is unreasonable to expect ultimate collection, revenue recognition should be postponed. Therefore, as per the accounting standard, if there is uncertainty in the receipt of the amounts, then the revenue in respect of such incentives ought not to be recognized in the books of accounts.

Therefore revenue is to be recognized only when there is reasonable certainty in the receipt of the same. Hence contention of management of T Ltd. to record the export incentive on cash basis is correct.

Note: An Alternative view is possible, since the export incentives are due as and when the exports have been made from India, though customs authorities does not acknowledge them as due. This does not mean that an uncertainty arises about its receipt. If at all customs authorities have an objection it should be at the time of clearance of the goods for export. The only uncertainty is the timing of the receipt of such incentives, but not the incentive itself. Hence T Ltd. has to account the export incentives on Accrual basis.

(b) Presentation of Book Overdraft as per Schedule III to the Companies Act, 2013: The instructions in accordance with which current assets being "cash and cash equivalents" should be made out to Part I of Schedule III to the Companies Act, 2013 states as follows-

(i) Cash and cash equivalents shall be classified as:

(a) Balances with banks;

(b) Cheques, drafts on hand;

(c) Cash on hand;

(d) Others (specify nature).

(ii) Earmarked balances with banks (for example, for unpaid dividend) shall be separately stated.

(iii) Balances with banks to the extent held as margin money or security against the borrowings, guarantees, other commitments shall be disclosed separately.

(iv) Repatriation restrictions, if any, in respect of cash and bank balances shall be separately stated.

(v) Bank deposits with more than 12 months maturity shall be disclosed separately.

From the facts of the case it is evident that in substance the position is that the composite bank balance including the balance in flexi deposit accounts are positive, even though physical set-off has not been made as on the balance sheet date. Further the bank has got the right to set off of flexi deposits against the cheques issued and hence it would be more informative and useful to the readers of the financial statements to disclose the book credit balance as a set-off from the flexi deposit accounts. The disclosure of the said book credit balance as book overdraft under the head current liabilities as proposed by the management is not correct.

Question 13

Comment on the following:

(a) B Co. Ltd. is engaged in the business of developing mass scale housing projects including development of small commercial complexes. The flats/commercial spaces are

booked by the public and are allotted by way of allotments letter to each allottee. Major construction activities pertaining to buildings are undertaken after allotment is over. After completing the construction, possession of flats/commercial spaces is given to allottees by executing legal document. The CEO of the B Co. Ltd. says that AS 7 is not applicable to the company.

(b) In the notes to accounts of C Co. Ltd. as on 31-03-2010 Note no. 11 states that 'Certain machinery items are lying at customs warehouses and company has paid ₹ 900 lakhs up to 30-06-2009 as detention charges, out of which a sum of ₹ 580 lakhs is written back during the year 2009-10 based on settlement with the concerned authorities in respect of a major spares of machinery. For the remaining machinery items negotiations are pending and a provision of ₹ 44 lakhs is made. As such total amount of ₹ 364 lakhs paid/provided on account of detention charges have been capitalized and included in the Fixed Assets/Capital work in progress. The management is of the view that these expenses are directly attributable to the acquisition of the related Fixed Asset.

(c) During the course of audit of D Co. Ltd. you as an auditor have observed that Inter Corporate deposit of ₹ 50 lakhs has been overdue. The D Co. Ltd. have disclosed this in the notes to accounts note No. 15 in schedule no. 21 stating that ₹ 50 lakhs is overdue from XYZ Co. Ltd. and the said company is in the process of liquidation. The management is taking steps to appoint the liquidator. (5 Marks each, November, 2010)

Answer

(a) Applicability of AS 7: The contention of the CEO of B Co. Ltd. is correct. AS 7 "Construction Contract", should be applied in accounting for construction contracts in the financial statements of contractors.

The activity of the B Co. Ltd. is not that of a contractor. The company is developing projects on its own account as a commercial venture and is in the nature of production activity and not that of a contractor. Therefore AS 7 will not be applicable to B Co. Ltd.

For the purpose of recognition of Revenue and valuation of inventories, B Co. Ltd. should follow the principles contained in AS 9 "Revenue recognition" and AS 2 "Valuation of Inventories".

(b) Accounting for Fixed Assets Lying at Custom Warehouses: As per AS 10 "Accounting for Fixed Assets", the cost of an item of fixed asset comprise its purchase price, including import duties and other non-refundable taxes or levies and any directly attributable cost of bringing the asset to its working condition for its intended use.

Generally, detention charges represent an abnormal expenditure, as these expenditures are not directly attributable to the cost of asset.

The auditor will qualify the report appropriately in the paragraph before stating that the Balance Sheet gives true and fair view and the Statement of Profit and Loss shows true and fair profit of the year ending on 31-3-2010. The qualification will be as follows:

"Attention is invited to Note no. 11 regarding Capitalization of detention charges of ₹ 364 lakhs during the year and on account of delays in respect of clearing from custom

warehouses for certain machinery items. In our opinion the detention charge are not directly attributable to the acquisition of related fixed assets. The said amount of ₹ 364 lakhs should have been written off in the Statement of Profit and Loss. Had these expenses been so written off the profit for the year would have been lower by ₹ 364 lakhs and Reserves & Surplus as well as Fixed Assets/Capital WIP would have been lower by ₹ 364 lakhs."

(c) As per AS 4 "Contingencies and Events occurring after the Balance Sheet Date", adjustments to assets and liabilities are required for events occurring after the balance sheet date that provide additional information materially affecting the determination of the amounts relating to conditions existing at the balance sheet date.

In the instant case, it appears from the note no 15 that the overdue of outstanding inter corporate deposit may not be realisable in full. The company is in the process of liquidation, makes it clear that on the balance sheet date, the amount of deposit is not safe and is not likely to be realised.

Therefore, as per AS 4 provision for the loss is required in the accounts. Hence the auditor should qualify the Audit Report.

Question 14

Mr. Ram, a relative of a Director was appointed as an auditor of the company. Comment.

(6 Marks, November, 2010)

Answer

Appointment of the Auditor: Section 141 of the Companies Act 2013 (herein after referred as the Act) deals with the eligibility, qualifications and disqualifications of Auditors. Sub-section (3)(f) of the Section 141 of the Act, explicitly disqualifies a person from being appointed as an auditor of a company whose relative is a director or is in the employment of the company as a director or key managerial personnel.

According to the Code of Ethics there is no direct restriction on a member to accept the audit of a company where his relative is director. Further, as per Clause 4 of Part 1 of the Second Schedule to the Chartered Accountants Act, 1949 there is professional misconduct if the member expresses his opinion on financial statements of any business or enterprise in which he, his firm or a partner in his firm has a substantial interest. Here also there is no mention of relative. But this clause has been inserted for the purpose of ensuring the independence of the auditor so that his opinion on the financial statements is an independent opinion free of any interest.

In August 2008, the council has issued a guideline in this respect. As per that guideline a member of the institute shall desist from expressing his opinion on financial statements of any business or enterprise in which one or more persons, who are his relatives within the meaning of AS-18, have either by themselves or in conjunction with such member, a substantial interest in the said business or enterprise. Therefore, if the director has substantial interest in the company then his relative should not accept the appointment of auditor of that company.

In the instant case, Mr. Ram is the relative of a Director of the Company, therefore he should not accept the appointment as an auditor of that company.

Question 15

While doing the audit, X, the Statutory Auditor of ABC Ltd. observes that certain loans and advances were made without proper securities, certain debtors and creditors were adjusted inter se, and personal expenses were charged to revenue. Comment. (6 Marks, November, 2010)

Answer

Audit Report: Section 143(1) of the Companies Act, 2013 requires the auditor to make an enquiry in respect of specified matters during the course of his audit. Since the law requires the auditor to make an enquiry, the Institute opined that the auditor is not required to report on the matters specified in sub-section (1) unless he has any special comments to make on any of the items referred to therein. If the auditor is satisfied as a result of the enquiries, he has no further duty to report that he is so satisfied. It is to be noted that the auditor is required to make only enquiries and not investigate into the matters referred to therein.

Clause (a) of Section 143(1) requires the auditor to inquire: "Whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are prejudicial to the interests of the company or its members".

If the auditor finds that the loans and advances have not been properly secured, he may enter an adverse comment in the report but cannot probably doubt the true view of the accounts by reference to this fact so long the loans and advances are properly described and presented in terms of Part I of Schedule III to the Companies Act. Further the auditor to inquire whether or not the terms on which the loans or advances have been made are prejudicial to the interests of the company or its members. If it is, he should qualify his report.

If debtors and creditors are adjusted inter se, this amounts to merely book entries. The auditor, as per clause (b) of section 143(1), should enquire "whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company". This proposition has got to be inquired into by reference to the effects of the book entries, unsupported by transactions, on the legitimate interests of the company. The auditor has to exercise his judgment based on certain objective standards".

Regarding Personal Expenses, Clause (e) of section 143(1) requires the auditor to inquire: "Whether personal expenses have been charged to revenue account". The charging to revenue of such personal expenses, either on the basis of the company's contractual obligations, or in accordance with accepted business practice, is perfectly normal and legitimate or does not call for any special comment by the auditor. Where, however, personal expenses not covered by contractual obligations or by accepted business practice are incurred by the company and charged to revenue account, it would be the duty of the auditor to report thereon. It suffices to say that if the auditor finds that personal expenses have been charged to revenue and if the amounts are material, he should qualify his report also.

In the instant case, Mr. X, the statutory auditor of ABC Ltd., needs to enquire in light of above provisions, as a result of the enquiries if he is satisfied then there is no further duty to report on these matters.

Question 16

Comment on the following:

(a) T Ltd. an Indian company, subject to Indian Income tax Act, 1961, discloses advance Income-tax paid (Current tax asset) and provision for Income-tax (Current tax liability), separately in Balance Sheet for the year ended 31.3.2010, i.e., it does not offset the amount.

(b) F Limited includes in the Schedule of Inventory, those items of Fixed assets which have not been in active use and held for disposal, as inventory item.(5 Marks each, May, 2010)

Answer

(a) Offsetting Assets and Liabilities: As per paragraph 27 of Accounting Standard (AS) 22– "Accounting for Taxes on Income", an enterprise should offset assets and liabilities representing current tax if the enterprise-

(i) has a legally enforceable right to set off the recognized amounts and

(ii) intends to settle the asset and liability on a net basis.

An enterprise will normally have a legally enforceable right to set off an asset and liability representing current tax when they relate to income taxes levied under the same governing taxation laws and the taxation laws permit the enterprise to make or receive a single net payment.

Since T Ltd is an Indian Company, and as per Income Tax Act, 1961, such set off is allowed which is legally enforceable. Thus, in view of Provisions of AS 22 and Income Tax Laws, T Ltd. should offset advance tax paid against provision for income tax and show only the net amount in the balance sheet.

(b) Accounting for Fixed Assets held for disposal: AS-10 "Accounting for Fixed Assets", requires that the items of fixed assets that have been retired from active use and are held for disposal be stated at the lower of their net book value and net realizable value and are shown separately in the financial statements. As per AS-2 "Valuation of Inventories", "inventories" are assets "held for sale in the ordinary course of business, in the process of production for such sale; or in the form of materials or supplies to be consumed in the production process or in the rendering of services.", whereas, the sale of fixed assets cannot be treated as sale arising from the ordinary course of business.

Thus, F Ltd's inclusion of fixed assets not in active use and held for disposal, as inventory item in the schedule of inventory is not in line with the requirements of AS-10 and AS-2. Such fixed assets should be stated at lower of net book value and net realizable value and are shown separately in financial statements.

Question 17

XYZ Limited received a grant of ₹ 25 lakhs under the Government's Subsidy Scheme, for acquiring an imported machinery for setting up new plant. The entire grant received is credited to Profit and Loss Account. Comment. (5 Marks, November, 2009)

Or

Dark Ltd. has received a grant of ₹ 20 lacs under the Government's Subsidy Scheme for acquiring an imported machinery for setting up an oil exploration plant and the entire grant received is credited to Profit and Loss account. (4 Marks, November, 2006)

Answer

Accounting for Government Grants: According to AS 12, "Accounting for Government Grants", where grant is received for the acquisition of a specific fixed asset, the same cannot be credited to Statement of Profit and Loss since it fails to match revenue with the cost.

As per AS 12, such grants should be presented in the balance sheet showing the grant as a deduction from the gross value of the asset concerned (in arriving at its book value). Alternately, the grants related to a depreciable fixed asset may be treated as deferred income which should be recognised in the Statement of Profit and Loss on a systematic and rational basis over the useful life of the asset. By crediting the entire amount of grant to the Statement of Profit and Loss, the company has treated it as a revenue income which is not in accordance with the requirements of the Accounting Standard.

Therefore, the statutory auditor would have to qualify appropriately that the income has been overstated to the extent of the amount of grant net of proportionate credit that would have been worked out.

Question 18

What do you understand about Reserved Capital as provided under Section 99 of the Companies Act, 1956? How is it different from Capital Reserve? (4 Marks, November, 2009)

Answer

This question is redundant in view of the provisions of the Companies Act, 2013.

Question 19

What are the duties of a statutory auditor regarding disqualification of a director u/s 274(1)(g) of the Companies Act, 1956 ? (8 Marks, June, 2009)

Answer

This question is redundant in view of the provisions of the Companies Act, 2013.

Question 20

X Ltd. did not follow the applicable Accounting Standard for disclosing Earnings Per Share (EPS) in the financial statements. The fact of such non-disclosure was however, mentioned in

the notes forming part of accounts. As the statutory auditor of X Ltd., how would you report in the above case? (5 Marks, June, 2009)

Answer

Disclosure of EPS is required for all companies as per AS 20 "Earnings per Share". AS 20 is also one of the AS notified by Section 133 of the Companies Act, 2013 read with the clarification given by the Ministry of Corporate Affairs (MCA) vide General Circular that the existing Accounting Standards notified under the Companies Act, 1956 shall continue to apply till it is prescribed by Central Government.

If the disclosures required by AS 20 are not made, it is the duty of the auditor to qualify in his report "Whether Accounting Standards under the clause as notified u/s 129(1) have been followed?" Mere disclosure by company in notes does not absolve him of his duty.

The same is, however, not a qualification to affect the "True & Fair" position of financial results of the company.

Question 21

Comment on the following:

(a) X Ltd. paid ₹ 25 lakhs as advance to Y Ltd. towards the purchase of a printing machinery on 15.1.08 with delivery instructions to deliver the same in the last week of June, 08. Further on 2.2.08 X Ltd. purchased two diesel generator sets from Y Ltd. for ₹ 30 lakhs on 90 days Credit term. In the accounts for 2007-08, X Ltd. intends to adjust the advance paid against Credit purchase and show the net amount of ₹ 5 lakhs as due from them. As the statutory auditor, how would you deal with this?

(b) The Statutory auditors of Getwell Ltd. included certain comments in his report u/s 227 of the Companies Act, 1956. Since the company requested the auditors to drop the above comments, as otherwise it will affect their future business, as a compromise the auditor included the comment in the report in ordinary type. (5 Marks each, November, 2008)

Answer

(a) Adjustment of Advances: Since X Ltd. has paid advance amount to the supplier of machinery to be used in the project, such advance amount should be grouped under the head 'Capital Work in Progress'. This is as per requirement of Schedule III to the Companies Act, 2013 and the existing accounting practice.

If the advance is for purchase of other machinery, it should be grouped under a separate head – say 'Advance Payment for Capital Expenditure' and should be disclosed as next item to Fixed Assets in the Balance Sheet.

In view of the above, the proposal of X Ltd., to show the net balance in the personal account of Y Ltd., is not correct. Such proposal will conceal the two material items in the balance sheet – one, expenditure towards capital asset and the other current liability for purchase of the generator set.

Hence, the auditor should advise X Ltd. to show these two items separately. If X Ltd. does not accept the advice, the auditor should qualify his report with suitable quantification of amount involved.

(b) This question is redundant in view of the provisions of the Companies Act, 2013.

Question 22

As Auditor of Act Fast Ltd. what steps will you take to ensure that the dividend has been paid only out of profit? *(8 Marks, November, 2008)*

Answer

The auditor may take the following steps to ensure that the dividend has been paid only out of profits:

1. Check whether the dividend was declared out of profits arrived at after providing for depreciation as per Section 123(2) of the Companies Act, 2013 (hereinafter referred as the Act).
2. Check whether-
   - (i) the depreciation was provided according to provision of Schedule II to the Act.
   - (ii) a board resolution recommending dividend was passed.
   - (iii) the dividend was declared only in the Annual General Meeting.
   - (iv) no dividend declared in general meeting exceeds the amount recommended by the Board.
   - (v) amount paid or credited as paid on a share in advance of calls is not treated for the purpose of this regulation as paid on the share.
   - (vi) register of members was closed as per the provisions of section 91 of the Act.
   - (vii) dividend has been paid in the prescribed manner within 30 days of time to the registered holder or their order for the compliance of Section 127 of the Act.
   - (viii) Amount of dividend deposited in a separate bank account within five days from the date of declaration of dividend.
   - (ix) intimation sent to Stock Exchange in the case of listed company.
   - (x) were there any complaints of non-payment/delayed payment of dividend? If so, whether corrective action was taken.

Question 23

As a Statutory Auditor, how would you deal with the following:

(a) While adopting the accounts for the year, the Board of Directors of Sunrise Ltd. decided to consider the Interim Dividend declared @15% as final dividend and did not consider transfer of Profit to reserves. *(4 Marks, May, 2008)*

(b) *V Ltd. sold 1 lakh vacuum pumps during the year 2006-07 with a condition to make good by repair/replacement any manufacturing defects reported within 6 months from the date of sale. Past experience in this regard showed that there were no replacements carried out, but minor/major repairs were necessitated to the extent of 10%/5% respectively of the units sold. The cost of such minor/major repairs would amount to ₹ 1,000/₹ 6,000 respectively. While finalizing the accounts for the year, the company does not reflect any provision, in this regard.* *(5 Marks, May, 2008)*

(c) *XYZ Pvt. Ltd., manufacturing garments, has valued at the year end its closing stock of packed finished goods for which firm export contracts have been received, at realizable value inclusive of profit and export cash incentive. As at the year end, the ownership of the goods has not been transferred to the foreign buyers.* *(4 Marks, May, 2008)*

Answer

(a) Declaration of Interim Dividend: Section 123(3) of the Companies Act, 2013 provides that the Board of Directors of a company may declare interim dividend during any financial year out of the surplus in the profit and loss account and out of profits of the financial year in which such interim dividend is sought to be declared. The amount of dividend including interim dividend should be deposited in a separate bank account within five days from the declaration of such dividend for the compliance of Section 123(4) of the said Act.

Based on Section 2(35) of the said Act, it can be said that since interim dividend is also a dividend, companies should provide for depreciation as required by Section 123 before declaration of interim dividend. However the first proviso to Section 123(1) provides that a company may, before the declaration of any dividend in any financial year, transfer such percentage of its profit for that financial year as it may consider appropriate to the reserves of the company irrespective of the size of the declared dividend i.e. the company is not mandatorily required to transfer the profit to the reserves, it is an option available to the company to transfer such percentage.

In the instant case, the Board has decided to pay interim dividend @15% of the paid-up capital. Assuming that the company has complied with the depreciation requirement, the interim dividend can be declared without transferring such percentage of its profits as it may consider appropriate to the reserves of the company.

(b) Provisions: As per AS – 29, 'Provisions, Contingent Liabilities and Contingent Assets', a provision is a liability which can be measured only by using a substantial degree of estimation.

As per AS – 29, a provision should be recognised when:

(i) An enterprise has a present obligation as a result of a past event.

(ii) It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and

(iii) A reliable estimate can be made of the amount of the obligation.

If these conditions are not met, no provision should be recognised.

In the present case, V Ltd. fulfils all the above conditions. The sale of pumps with a warranty obligation constitutes the present obligation as a result of past event. It is probable that some outflow will be involved in setting the warranty obligation, satisfy the second condition. As per the details based on past precedence reliable estimate can be made as under:

[6000 × (5% of 100000) + 1000 × (10% of 100000)] = ₹ 400 lakhs

Thus, V Ltd as on 31.3.07 should make a provision for warranty obligation against sale of vacuum pumps to the extent of ₹ 400 lakhs. The auditor should insist on such provision being created. If provision is not made he should qualify his audit report.

(c) Valuation of Inventories: AS 2 requires that inventories should be valued as lower of cost and Net realisable value (NRV). A departure from the general principle can be made if the AS is not applicable or having regard to the nature of industry.

AS 2 also states that (a) work in progress arising under construction contracts, including directly related service contracts (b) work in progress arising in the ordinary course of business of service providers;(c) shares, debentures and other financial instruments held as stock-in-trade; and(d) producers' inventories of livestock, agricultural and forest products are measured as NRV based on established practices.

In the given case the sale is assumed under a forward contract but the goods are not of a nature covered by the above exceptions Taking into account the facts the closing stock of finished goods should have been valued at cost, as it is lower than the realisable value (as it includes profit). Further, export cash incentives should not be included for valuation purposes.

The policy adopted by the company for valuing its closing stock of inventory of finished goods on selling price plus export incentives is not correct. The statutory auditor should give a qualified report.

Question 24

What are the steps to be taken by a firm of Chartered Accountant to ensure that its appointment as Statutory Auditor of a Company is valid? (6 Marks, May, 2008)

Answer

Validity of Appointment as a Statutory Auditor: To ensure that the appointment is valid, the incoming auditor should take the following steps before accepting his appointment-

(i) Ceiling limit: Ensure that a certificate has been issued under section 139 of the Companies Act, 2013 so that the total number of company audits held by the firm (including the new appointment) will not exceed the specified number.

(ii) Resolution at AGM: Verify that at AGM of the Company, a proper resolution is passed. Inspect general meeting minutes book to see that the appointment is duly recorded.

(iii) Compliance with law: Satisfy that the legal procedure contemplated in section 139 and 140 of the said Act, dealing with the appointment and removal of existing auditor, have been followed. Also check whether section 139(5) and 139(7) (in case of a government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government, or Governments, or partly by the Central Government and partly by one or more State Governments- appointment by the Comptroller and Auditor General of India) are attracted and complied with.

(iv) Code of conduct: Communicate with the previous auditor, if any, in writing, to ascertain if there are any professional reasons for not accepting the appointment.

Question 25

Write short notes on the following:

(a) Key Management Personnel

(b) Normal Capacity for the purpose of Inventory valuation

(c) Integral Foreign Operations. *(4 Marks each, May, 2008)*

Answer

(a) Key Management Personnel: As per AS 18 on Related Party Disclosures, "Key management personnel" are those persons who have the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise.

Further, Section 2(51) of the Companies Act, 2013 also defines the "key managerial personnel" in relation to a company as the Chief Executive Officer or the managing director or the manager; the company secretary; the whole-time director; the Chief Financial Officer; and such other officer as may be prescribed.

It may be noted here that non-executive directors of a company will not be considered as key management personnel under AS 18 by virtue of merely their being directors, unless they have the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise.

Further, the requirements of AS 18 should not be applied in respect of a non-executive director even if he participates in the financial and/or operating policy decision of the enterprise unless he falls in any of the categories discussed in Para 3 of AS 18.

(b) Normal Capacity for Inventory Valuation: As per AS 2 on Valuation of Inventories, allocations of fixed production overheads for the purpose of their inclusion in the costs of conversion is based on the normal capacity of the production facilities.

Normal capacity is the production expected to be achieved on an average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance. The actual level of production may be used if it approximates normal capacity. Due to this, the fixed overhead allocated to each unit of production is not increased as a consequence of low production or idle plant. In periods of high production, these overheads allocated are decreased so that inventories are not measured above cost.

(c) Integral Foreign Operations: As per AS 11 on The Effects of Changes in Foreign Exchange Rates, there are foreign operations, the activities of which are an integral part of the reporting enterprise. This is important since the method used to translate financial results of a foreign operation depends on the way in which it is financed and operates in relation to the reporting enterprise.

A foreign operation that is integral to the operation of the reporting enterprise carries on its business as if it were an extension of the reporting enterprise's operations. In such cases, change in exchange rates between the reporting currency and the currency in the country of foreign operation has an almost immediate effect on the reporting enterprise's cash flow from operations. Therefore, the change in the exchange rates affects the individual monetary items held by the foreign operation rather than the net investment in that operation.

Question 26

As a Statutory Auditor, how would you deal with the following:

(a) Z Ltd. provided, ₹ 5 lakhs for inventory obsolescence in the last year's accounts. In the subsequent year, it was determined that 50% of this stock was actually usable. The Company wants to adjust the same as a "Prior period adjustment". (5 Marks, November, 2007)

(b) A company capitalises interest on borrowings incurred for holding investments by adding the same to the cost of investment every year. (4 Marks, November, 2007)

(c) X Ltd. is engaged in manufacture of Cement. In the Profit and Loss Account for the year ended 31st March, 2007, it discloses its revenue from sales transactions (turnover) net of excise duty. The excise duty collected and paid on sales transactions and that related to difference between Closing stock and Opening stock is, however, disclosed in the "Notes to Accounts". (4 Marks, November, 2007)

Answer

(a) Prior Period Adjustment: As per Accounting Standard 5 "Net Profit or Loss for the period, Prior Period Items and Change in Accounting Policies", Prior period items are income or expenditure which arise in the current period as a result of errors or omissions in the preparation of the Financial Statements of one or more prior periods.

The write back of provision made in respect of inventories in the earlier year does not constitute prior period adjustment since it neither constitutes error nor omission but it merely involves making estimates based on prevailing circumstances when Financial Statements were being prepared.

An estimate may have to be revised -

(i) If changes occur in the circumstances on which the estimate was based or

(ii) as a result of new information, more experience or subsequent developments.

The revision of the estimate, by its nature, does not bring the adjustment within the definitions of an extraordinary item or a prior period item.

A change in an accounting estimate may affect the current period only or both the current period and future periods. In both cases, the effect of the change relating to the current period is recognised as income or expense in the current period. The effect, if any, on future periods, is recognised in future periods.

Further, as per SA 540 "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures", the auditor shall review the outcome of accounting estimates included in the prior period financial statements or where applicable, their subsequent re-estimation for the purpose of the current period.

In this case, Z Ltd. provided ₹ 5 lakhs for inventory obsolescence in last year's accounts. In the subsequent year due to change in circumstances, it was determined that 50% of such stock was usable. Revision of such an estimate does not bring the resulting amount of ₹ 2.5 lakhs within the definition either of a prior period item or of an extraordinary item. The amount, however, involved is material and requires separate disclosure to understand the financial position and performance of an enterprise. Accordingly, adjustment in the value of the inventory through prior period item would not be proper.

(b) Capitalisation of Interests: Investments are assets held by an enterprise for earning income by way of dividends, interest, and rentals, for capital appreciation, or for other benefits to the investing enterprise. As per AS-13 "Accounting for Investments", cost of investments includes acquisition charges such as brokerage, fees and duties. As per AS 16 "Borrowing Costs", borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalized as part of the cost of that asset. Other borrowing costs should be recognised as an expense in the period in which they are incurred. A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. Assets that are ready for their intended use or sale when acquired are not qualifying assets. Therefore such investment is not a qualifying asset, therefore interest cost of holding investments cannot be capitalized.

(c) Disclosure Requirement of Excise Duty: As per Accounting Standard Interpretation – ASI 14 ' Disclosure of Revenue from Sales Transactions' (Revised) issued by ICAI in Aug 2006, the amount of turnover should be disclosed as follows on the face of the Statement of Profit and Loss:

Turnover (Gross)	XX
Less : Excise duty	XX
Turnover (Net)	XX

Further, the excise duty shown above should be the total duty except the duty related to the difference between closing stock & opening stock which should be recognized separately in the Statement of Profit and Loss, with an explanatory note in the notes to accounts to explain the nature of the two amounts of excise duty.

Since the company, X Ltd has not followed the above ASI 14, the auditor would have to qualify his report accordingly.

Question 27

What is the meaning of "Small and Medium sized Company" as per the Companies (Accounting Standards) Rules, 2006? *(8 Marks, November, 2007)*

Answer

This question is redundant in view of the provisions of the Companies Act, 2013.

Question 28

Write a short note on Purchase method of Accounting for amalgamations.

(4 Marks, November, 2007)

Answer

Purchase Method of Accounting for Amalgamation: As per AS 14 on Accounting for Amalgamations, there are two main methods of accounting for amalgamations i.e. the pooling of interests method and the purchase method. Under the purchase method in preparing the transferee company's financial statements, the assets and liabilities of the transferor company should be incorporated at their existing carrying amounts or, alternatively, the consideration should be allocated to individual identifiable assets and liabilities on the basis of their fair values at the date of amalgamation. The reserves (whether capital or revenue or arising on revaluation) of the transferor company, other than the statutory reserves, should not be included in the financial statements of the transferee company. Any excess of the amount of the consideration over the value of the net assets of the transferor company acquired by the transferee company should be recognised in the transferee company's financial statements as goodwill arising on amalgamation. If the amount of the consideration is lower than the value of the net assets acquired, the difference should be treated as Capital Reserve. The goodwill arising on amalgamation should be amortised to income on a systematic basis over its useful life. The amortization period should not exceed five years unless a somewhat longer period can be justified. Where the requirements of the relevant statute for recording the statutory reserves in the books of the transferee company are complied with, statutory reserves of the transferor company should be recorded in the financial statements of the transferee company. The corresponding debit should be given to a suitable account head (e.g., 'Amalgamation Adjustment Account') which should be disclosed as a part of 'miscellaneous expenditure' or other similar category in the balance sheet. When the identity of the statutory reserves is no longer required to be maintained, both the reserves and the aforesaid account should be reversed.

Question 29

As an auditor, how would you deal with the following?

(a) *In the audit of ABC Private Limited, auditor came across cases of payments to Directors, whereby, expenses of a personal nature were re-imbursed.* *(5 Marks, May, 2007)*

(b) *The management of a limited company states that proposed dividend does not represent a liability and hence no provision need to be made.* *(4 Marks, May, 2007)*

Answer

(a) Reimbursement of Personal Expenses of Director: All payments to Directors as remuneration or perquisites whether in the case of a public or private company are required to be authorised both in accordance with the Companies Act and Articles of Association of the company. Articles may provide that such remuneration require sanction of the shareholders either by ordinary or special resolution while in some cases it may require only approval of Directors. If the terms of appointment of a Director include payment of expenses of a personal nature, then such expenses can be incurred by the company; otherwise, no such expense can be incurred or reimbursed by the company. In the instant case the auditor has to ensure that the above is complied with, without which, if such expenses are paid, he has to disclose the fact in his report, as also in the accounts. In this regard attention is invited to section 143(1)(e) of the Companies Act, 2013 wherein auditor has to inquire into whether personal expenses have been charged to revenue.

(b) Provision for Proposed Dividend: The Schedule III to the Companies Act, 2013, requires disclosure of the amount of dividends proposed to be distributed to equity and preference shareholders for the period and the related amount per share to be disclosed separately. It also requires separate disclosure of the arrears of fixed cumulative dividends on preference shares.

Further, as per AS 4 "Contingencies and Events Occurring After the Balance Sheet Date", there are events which, although take place after the balance sheet date are sometimes reflected in the financial statement because of Statutory requirement or because of their special nature and such item includes the amount of dividend proposed or declared by the enterprise after the balance sheet date in respect of the period covered in the financial statements.

Hence, a question that arises is as to whether this means that proposed dividend is not required to be provided for when applying the Schedule III.

Keeping this in view and the fact that the Accounting Standards override Schedule III to the Companies Act, 2013, companies will have to continue to create a provision for dividend in respect of the period covered by the financial statement and disclose the same as a provisions in Balance Sheet, unless AS 4 is revised.

Despite the change in treatment/disclosure of proposed dividend is made under Schedule III, the same would not be applicable till consequential amendment is made under AS 4.

In the instant case, management of the company states that the proposed dividend does not represent a liability hence, no entry has been passed in the books of the company.

Contention of the directors for non provision of proposed dividend is not correct since Accounting Standard overrides Schedule III to the Companies Act, 2013. Therefore, company need to create provision for the same in its financial statements.

Question 30

A company wants to amend its accounts after the completion of the audit and adoption of the Accounts by the Board, but before circulation to the shareholders. It requires its statutory auditor to report on the amended accounts. State the steps the statutory audit should adopt in such a situation. *(8 Marks, May, 2007)*

Answer

Amendment of Accounts After the Completion of the Audit and Adoption of the Accounts by the Board Before Circulation to the Shareholders: This pertains to the manner in which the statutory auditor should report upon amended accounts. The Companies Act does not contemplate the revision of accounts and a further report by the statutory auditor on the amended accounts. At the same time, it is entirely within the competence of the Board of Directors to amend the accounts and resubmit the same to statutory auditors for report before the accounts are placed before the Annual General Meeting. The report issued by the statutory auditor on such amended accounts will be in substitution of the report issued before the amendment. Unless all copies of the original accounts and reports are returned to the auditor, such substitution is not possible.

The Guidance Note on "Auditor's report on revised accounts of companies before circulation to shareholders" recommends that members, when called upon to issue a report on amended accounts for the same period due to amendments to the accounts, should ensure all copies of the original accounts and reports are returned to him, adequate disclosure about the revision of accounts already reported, appears as a specific note on the amended accounts. If the Statutory auditor is satisfied about the adequacy of disclosure, there may not be any further need for him to refer to the revision of balance sheet and/or the Statement of Profit and Loss in his report otherwise he has to refer to the revision in his report. However, if the Notes to accounts do not contain any note on the revision or if such a note is contained therein but not considered by the statutory auditor as adequately comprehensive, it will be the duty of the statutory auditor to refer to the fact of revision of the accounts in his report.

(Note - The answer to this question would be based on provisions of Section 131 of the Companies Act, 2013 which is yet to be notified.)

Question 31

As a Statutory Auditor, how would you deal with the following:

(a) Mr.Rajesh is appointed as the auditor of NOIDA Travels Ltd. with audit fees of ₹ 35,000. He purchased air ticket from Delhi to Kolkata and back for ₹ 18,000 from the client for his personal work and the amount remains unpaid at the end of the year as it is a general practice of the client to give credit to all. Mr. Rajesh claims that he does not incur any disqualification as contained in Section 226(3)(d) of the Companies Act.

(5 Marks, November, 2006)

(b) Apex Ltd., a well reputed manufacturing public limited company has made a contribution of ₹ 2.5 lacs during the financial year ended 31.3.06 to a political party for running a school, situated in the village, where most of the workers of the company reside. It is

admitted that the benefit of the school is mostly for the children of the workers of the company. The company has not made any profits in the last four years.

(4 Marks, November, 2006)

Answer

(a) This question is redundant in view of the provisions of the Companies Act, 2013.

(b) Restrictions Regarding Political Contribution: Section 182 of the Companies Act, 2013 deals with prohibitions and restrictions regarding political contributions. According to this section, a government company or any other company which has been in existence for less than three financial years cannot contribute any amount directly or indirectly to any political party. In other cases, contribution in any financial year should not exceed 7½ % of average net profits during the three immediately preceding financial years. The company in question has not made any profit in last four years and contributed ₹ 2.5 lacs during the year to a political party for running a school. This is violation of the provisions of Section 182 of the said Act although the children of its workers are benefited. The auditor would have to qualify his report stating the contravention of the provisions of the Companies Act.

Question 32

State the salient features of the directions to the auditors of Government companies issued by the Comptroller and Auditor General of India u/s 619(3) of the Companies Act, 1956 in relation to:

(i) Assets and Investments, and

(ii) Inventory and Contracting. *(8 Marks, November, 2006)*

Answer

This question is redundant in view of the provisions of the Companies Act, 2013.

Question 33

Write a short note on Effect of uncertainties on revenue recognition.(4 Marks, November, 2006)

Answer

Effect of Uncertainties on Revenue recognition: Para 9 of AS 9 "Revenue Recognition" deals with the effect of uncertainties on revenue recognition. The Para states-

(i) Recognition of revenue requires that revenue is measurable and at the time of sale or the rendering of the service it would not be unreasonable to expect ultimate collection.

(ii) Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, e.g. for escalation of price, export incentives, interest etc., revenue recognition is postponed to the extent of uncertainty involved. In such cases it may be appropriate to recognize revenue only when it is reasonably certain that the ultimate collection will be made. When there is no uncertainty as to ultimate collection, revenue is

recognized at the time of sale or rendering of service even though payments are made by instalments.

(iii) When the uncertainty relating to collectability arises subsequent to the time of sale or rendering of the service, it is more appropriate to make a separate provision to reflect the uncertainty rather than to adjust the amount of revenue originally recorded.

(iv) An essential criterion for the recognition of revenue is that the consideration receivable for the sale of goods, the rendering of services or from the use by others of enterprise resources is reasonably determinable. When such consideration is not determinable within reasonable limits, the recognition of revenue is postponed.

(v) When recognition of revenue is postponed due to effect of uncertainties, it is considered as revenue of the period in which it is properly recognised.

Question 34

As a statutory auditor, how would you deal with the following:

(a) A Pvt. Ltd., started stock broking activities in 2005. For this purpose it acquired membership of a stock exchange for ₹ 110 lacs. While finalizing the accounts, the company disclosed the above amount under the Fixed Assets schedule as "Stock Exchange Membership Rights". The company also did not write off any amount since the rights would enable the company to perpetually carry on its business.(5 Marks, May, 2006)

(b) ABC Ltd. having a paid up capital of ₹ 1 crore earned as total net profit of ₹ 1 crore for the years 2001-02 to 2003-04. The Company did not declare any dividend nor transferred any amount to Reserves for these years. The entire profit was retained in the Profit & Loss Account.

In 2004-05, the company made a profit of ₹ 20 lacs. The company also proposed in 2004-05 to declare dividend @25% out of accumulated profits. (4 Marks, May, 2006)

(c) XYZ Ltd. had received a grant of ₹ 50 lacs in 1997 from a State Government towards installation of pollution control machinery on fulfillment of certain conditions. The company, however, failed to comply with the said conditions and consequently was required to refund the said amount in 2005.

The company debited the said amount to its machinery in 2005 on payment of the same. It also reworked the depreciation for the said machinery from the date of its purchase and passed necessary adjusting entries in the year 2005 to incorporate the retrospective impact of the same. (5 Marks, May, 2006)

Answer

(a) Stock Exchange Membership Rights: A Pvt. Ltd. has paid ₹ 110 lacs for acquiring membership of stock exchange. Such membership rights provide exclusive right to A Pvt. Ltd. for carrying out stock broking activities. Thus, Stock Exchange Membership Rights are controlled by A Pvt. Ltd. and provide the basis for generating economic benefits to it. All these criteria appear to meet the definition of intangible assets as laid down in AS 26, "Intangible Assets". The Standard requires an entity to recognize an intangible asset if it

is probable that the future economic benefits that are attributable to the asset will flow to the enterprise and the cost of the asset can be measured reliably. In the instant case, membership rights of stock exchange acquired by A Pvt. Ltd. meet the criteria of identifiability, control and arising of future benefits as well as reliability of the amount of cost. Thus recognizing the membership rights as Fixed Assets is proper.

However, the fact that the company did not write-off any amount since it would enable the company to perpetually carry on its business is not proper since AS 26 requires that all Intangible Assets to be amortised. For this purpose, a rebuttable presumption of 10 years is to be considered. Hence in the instant case, the company should have amortised such rights over 10 years. Since the company has not amortised any amount, the auditor will have to qualify his report and state the fact of non-compliance with AS 26.

(b) This question is redundant in view of the provisions of the Companies Act, 2013.

(c) Refund of Government Grant: As per facts of the case, XYZ Ltd. had received a grant of ₹ 50 lacs in 1997 from a State Government towards installation of pollution control machinery on fulfilment of certain conditions. However, the amount of grant has to be refunded since it failed to comply with the prescribed conditions. In such circumstances, AS 12, "Accounting for Government Grants", requires that the amount refundable in respect of a government grant related to a specific fixed asset is recorded by increasing the book value of the asset or by reducing the capital reserve or the deferred income balance, as appropriate, by the amount refundable. The Standard further makes it clear that in the first alternative, i.e., where the book value of the asset is increased, depreciation on the revised book value should be provided prospectively over the residual useful life of the asset. Accordingly the accounting treatment given by XYZ Ltd. of increasing the value of the plant and machinery is quite proper. However, the accounting treatment in respect of depreciation given by the company of adjustment of depreciation with retrospective effect is improper and constitutes violation of both the AS 6, "Depreciation Accounting" and AS 12, "Accounting for Government Grants".

The auditor, therefore, should discuss with the management to make necessary changes in respect of same and if not agreed to, qualify the report quantifying the impact of the same on profit as well as assets of the company.

Question 35

Write short notes on the following:

(a) Remuneration to Statutory Auditors under the Companies Act, 1956

(b) Deferred Taxation *(4 Marks each, May, 2006)*

Answer

(a) This question is redundant in view of the provisions of the Companies Act, 2013.

(b) Deferred Taxation: AS 22 "Accounting for Taxes on Income", prescribes the accounting treatment for taxes on income. The amount of taxable income for a period and the amount of profit (or loss) as shown by the Statement of Profit and Loss for that period are

seldom the same. The difference between accounting income and taxable income arise due to the fact that taxable income is calculated in accordance with tax laws whose requirements regarding computation of taxable income differ from the accounting policies applied to determine accounting income. The difference between taxable income and accounting income can be classified into 'permanent differences' and 'timing differences'. 'Permanent differences' are the differences between taxable income and accounting income for a period that originate in one period and do not reverse subsequently. Timing differences, on the other hand, are those differences between taxable income and accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods. The standard requires that deferred tax should be recognized for all timing differences, subject to the consideration of prudence in respect of deferred tax assets. Deferred tax represents the future tax effects of timing differences. Some timing differences are such that their reversal in future year(s) would result in the taxable income for the year(s) of reversal being higher than the accounting income for that year (or those years).

Question 36

As a Statutory Auditor, how would you deal with the following:

(a) *ABC Ltd. commenced construction of a flyover in Mumbai in January, 2004 under BOLT scheme. The same was completed in February, 2005. Due to seasonal heavy rains in July, 2004 in the area, the work on the flyover had to be suspended for 1 month. The company accordingly suspended borrowing costs of ₹ 12.50 lakhs for that month from capitalization.* *(5 Marks, November, 2005)*

(b) *P Ltd. of whom you are the Statutory Auditor appoints M/s XYZ as Branch Auditors for one of its branches. M/s XYZ conducted the audit of the branch without visiting the branch and instead getting the books at the H.O. M/s XYZ has submitted their Branch Audit Report to you.* *(5 Marks, November, 2005)*

(c) *LM Ltd. has 2 divisions L and M. The finished products of division L are transferred to division M where further processing is carried out before sale to customers. To achieve transparency and accountability between the divisions, division L raises an invoice on division M at cost plus normal margins. At the year end the unrealized profits on inter-division stocks are eliminated. However, the transfers are recorded at the invoice value as sales and purchases in the respective divisions for the purpose of preparing the Profit and Loss Account. Suitable disclosures, for this are given in then 'Notes to Accounts'.* *(5 Marks, November, 2005)*

(d) *T Pvt. Ltd. is an unlisted closely held company with turnover less than ₹ 50 crores. While finalizing the accounts, Mr. M the Director (finance) disputed the applicability of AS 20 to the company.* *(3 Marks, November, 2005)*

Answer

(a) Capitalisation of Borrowing Costs: Borrowing costs may be incurred during an extended period in which the activities necessary to prepare an asset for intended use or sale are interrupted. According to AS-16, "Borrowing Costs", capitalisation of such

borrowing costs should be suspended during extended periods in which active development is interrupted. The standard, however, clarifies that capitalisation of borrowing costs is not suspended when a temporary delay is necessary as a part of the process or substantial technical and administrative work is being carried out. Thus, the test as to whether or not to capitalise the borrowing costs depends primarily upon the nature of interruption of activities during "extended periods".

In the instant case, it has been mentioned that the construction activity was interrupted due to seasonal rain and hence being regular feature. Though the rain was heavy, the period cannot be considered as an "extended period" leading to substantial delay in suspension of construction activities. Therefore, borrowing cost of ₹ 12.50 lakhs incurred by ABC Ltd. should be capitalized. Hence, suspension of capitalization by the company is not a correct treatment and statutory auditor should report accordingly.

(b) Branch Auditor's Report: As per provisions of the Companies Act, 2013, the accounts of a branch office of a company are required to be audited either by the company's auditor or by any other person qualified for appointment as auditor of the company. It is not necessary for branch auditor M/s XYZ to visit the branch and conduct the audit only at branch's premises. It is a matter of professional judgement for the branch auditor to decide as to whether he needs to visit the branch. At the same time, the statutory auditor has the right to visit branch offices and to have access to the books of accounts and vouchers maintained at the branch office in this case.

In any case, the principal auditor i.e. the statutory auditor of Head Office P Ltd. is entitled to rely on the work of branch auditor unless there are special circumstances to make it essential for him to visit the branch and examine the books of account and voucher records. As per basic principles governing an audit, the principal auditor is entitled to rely upon the work performed by others provided he exercises adequate skill and care and is not aware of any reason to believe that he should not have so relied. As per SA 600, "Using the work of another auditor", the principal auditor is not required to evaluate professional competence because branch auditor happens to be member of ICAI. The statutory auditor is also required to deal with the Branch Auditor's report in the manner, he considers necessary. Therefore, the statutory auditor is required to deal with M/s XYZ's report in the manner it considers fit under the circumstances.

(c) Revenue Recognition: As per the definition of the term "Revenue" in AS 9, "Revenue Recognition", revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them.

As per the clarification issued by ICAI, the use of the word "enterprise" in the above definition clearly implies that the transfers within the enterprise cannot be considered as fulfilling the definition of the term "revenue". Thus, the recognition of inter-divisional transfers as sales is an inappropriate accounting treatment and is inconsistent with AS 9.

Further, in case of inter-divisional transfers, risks and rewards remain within the enterprise and also there is no consideration from the point of view of the enterprise as a whole. Thus, the recognition criteria for revenue recognition are also not fulfilled in respect of inter-divisional transfers.

In the instant case, therefore, LM Ltd cannot recognise inter-division transfers from L to M as sales and the same will have to be eliminated during finalisation. If not so done, the statutory another will have to qualify his report.

(d) Applicability of Accounting Standard: AS 20, "Earning Per Share", came into effect in respect of accounting periods commencing on or after 1-4-2001 and is mandatory in nature, from that date, in respect of enterprises whose equity shares or potential equity shares are listed on a recognised stock exchange in India. As such AS 20 does not mandate an enterprise, which has neither equity shares nor potential equity shares which are so listed, to calculate and disclose earnings per share, but, if that enterprise discloses earnings per share for complying with the requirements of any statute or otherwise, it should calculate and disclose earnings per share in accordance with AS 20. Part II of Schedule III to the Companies, Act, 2013, requires, among other things, disclosure of earnings per share. Accordingly, every company, which is required to give information under Part II of Schedule III to the Companies Act, 2013, should calculate and disclose earnings per share in accordance with AS 20, whether or not its equity shares or potential equity shares are listed on a recognised stock exchange in India.

Accordingly the company, T Pvt. Ltd should compute and disclose EPS according to AS 20. Therefore, the contention of Director (Finance) is incorrect. The auditor will have to ensure that EPS is disclosed as per AS 20 or else the auditor should appropriately modify the audit report.

Question 37

What are the statements of facts that an auditor has to report u/s 227 of the Companies Act, 1956? *(4 Marks, November, 2005)*

Answer

This question is redundant in view of the provisions of the Companies Act, 2013.

Question 38

Write a short note on Recognition of Deferred Tax Assets. *(4 Marks, November, 2005)*

Answer

Recognition of Deferred Tax Assets: Deferred Tax Assets (DTA) is to be recognised as laid down by AS 22 "Accounting for Taxes on Income". A DTA arises on account of a timing difference in which the taxable income is more than the book income. A deferred tax asset (and the corresponding tax saving) should be recognised only after applying the test of prudence. Thus, where the enterprise does not have unabsorbed depreciation and carried forward losses as per the tax laws, deferred tax assets should be recognised and carried forward to the extent that there is a reasonable certainty that sufficient future taxable income

will be available against which such deferred tax assets can be realized. In other words, no deferred tax asset should be created if there is no reasonable certainty about the requisite future taxable income. The existence or absence of a reasonable level of certainty would normally be determined by examining the past record of the reasonable and by making realistic estimates of profits for the future.

A much stricter test of prudence has to be satisfied where the enterprise has unabsorbed depreciation or carried forward losses under tax laws. In such a situation, deferred tax assets should be recognised only to the extent that there is virtual certainty supported by convincing evidence that sufficient future taxable income will be available against which such deferred tax assets can be realized. The existence of unabsorbed depreciation or carried forward losses under tax laws is strong evidence that future taxable income may not be available. Therefore, in such a situation, the enterprise can recognise deferred tax assets only to the extent that it has timing differences the reversal of which will result in sufficient taxable income or there is other convincing evidence of virtual certainty of availability of sufficient taxable income against which deferred tax assets can be realized.

ICAI has stated that virtual certainty refers to the extent of certainty which, for all practical purposes, can be considered certain. Virtual certainty cannot be based merely on forecasts of performance such as business plans. Determination of virtual certainty of availability of sufficient future taxable income is a matter of judgement which will have to be made on a case-to-case basis.

Question 39

As a Statutory Auditor, how would you deal with the following:

(a) P Pvt. Ltd. was amalgamated with PQR Ltd. with effect from 1st April, 2004. As per the scheme of amalgamation approved by the High Court, the amalgamation was to be accounted by the "Pooling of Interests Method". The scheme further provided that the balance in Revaluation Reserve of P Pvt. Ltd. as on 31st March, 2004 was to be treated as a General Reserve on amalgamation. During the financial year 2004-05, PQR Ltd. issued bonus shares out of General Reserves (which included the amount of revaluation reserve of P Pvt. Ltd.)

(b) B Pvt. Ltd., implements a Voluntary Retirement Scheme (VRS) for its employees. It follows a policy of amortising the expenditure over 10 years. As at 1st April, 2004, the unamortised VRS expenditure was ₹ 15 lakhs. During the year 2004-05, it incurred further ₹ 12 lakhs as VRS. For the year ended 31st March, 2005, the company proposes to revise the period of amortisation to 5 years. It also proposes to follow the revised period for the opening balance. (5 Marks each, May, 2005)

Answer

(a) Amalgamation and Revaluation Reserve: As per AS 14, "Accounting for Amalgamations" if the amalgamation is in the nature of merger and the 'Pooling of Interest Method' is followed, the identity of the reserves is preserved and it appears in the financial statements of the transferee company in the same form in which they appeared in the financial statements of the transferor company. In the instant case, P Pvt. Ltd is amalgamated with PQR Ltd. and the amalgamation is in the nature of merger.

Accordingly, Revaluation Reserves of P Pvt. Ltd. would have normally continued to remain so in PQR Ltd. However, since the scheme mentions that Revaluation Reserve is to be treated as General Reserves, the scheme will override AS 14. AS 14, "Accounting for Amalgamations", also requires that in case of any approved scheme of amalgamation if the treatment in accounting is not as per the AS, a specific disclosure of the same will have to be made along with the financial effect on the financial statements due to such deviation. The statutory auditor will accordingly have to ensure that the company complies with the requirements regarding treatment of reserves and other related disclosure requirements or he may be required to modify his report.

(b) Expenditure on Voluntary Retirement Scheme: AS 26, "Intangible Assets", deals with expenditure incurred on intangible items by all enterprises, except amongst others, is not applicable to expenditure in respect of termination benefits. As per the standard, termination benefits are employee benefits payable as a result of either an enterprises' decision to terminate an employee's employment before the normal retirement date; or an employee's decision to accept voluntary redundancy in exchange for those benefits (voluntary retirement). Accordingly, Voluntary Retirement Scheme (VRS) is one form of termination benefit and hence AS 26 principles are not applicable. The same has to be, therefore, accounted as per general accepted accounting practices. Accordingly, VRS expenditure would have to be written off / amortised over a reasonable period. In fact, the change of the accounting policy followed by the company to reduce the amortisation period to 5 years for the entire VRS expenditure including opening balance seems appropriate and reasonable. The auditor, however, has to examine that the requirements of AS 5, "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" and impact of change in accounting policy is also disclosed as per AS 1, "Disclosure of Accounting Policies".

Question 40

You have been appointed the sole statutory auditor of a company where you were one of the joint auditors in the immediately preceding year. The concerned joint auditor has not been reappointed. What are the various steps you would take to ascertain the compliance of the requirements of the Companies Act, 1956 before accepting the audit? (5 Marks, May, 2005)

Answer

This question is redundant in view of the provisions of the Companies Act, 2013.

Question 41

When can a company be said to have 'Not maintained' proper books of account? What is the role of the statutory auditor for the same? (6 Marks, May, 2005)

Answer

Section 128(1) of the Companies Act, 2013 (herein after referred as the Act) requires that every company shall prepare and keep at its registered office books of account and other relevant books and papers and financial statement for every financial year which give a true and fair view of the state of the affairs of the company, including that of its branch office or offices, if any, and explain the transactions effected both at the registered office and its branches and such books shall be

kept on accrual basis and according to the double entry system of accounting. Further, the definition of "financial statement" in relation to a company, given under section 2(40) of the Act includes a balance sheet as at the end of the financial year; a profit and loss account, or in the case of a company carrying on any activity not for profit, an income and expenditure account for the financial year; cash flow statement for the financial year (One Person company, small company and dormant company, may not include the cash flow statement); a Statement of changes in equity (if applicable); and any explanatory note annexed to, or forming part of, any of the document referred before.

Section 129(1) of the Act, requires that the financial statements shall give a true and fair view of the state of affairs of the company, comply with the accounting standards notified in this Act and shall be in the form as provided in Schedule III to this Act. It is also provided that the provisions contained in this sub-section shall not be applicable to any insurance or banking company or any company engaged in the generation or supply of electricity, or to any other class of company for which a form of financial; statement has been specified in or under the Act governing such class of company.

The provisions mentioned above are required to be followed by the company to maintain proper books of accounts. The Auditor is required to check that the company has complied with all the provisions related to maintenance of books of accounts etc.

Further, the books have to be maintained under accrual system and if the statutory auditor finds the books are not maintained accordingly, he will have to modify his report.

According to Section 143(3)(b), the auditor's report shall also state whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books and proper returns adequate for the purposes of his audit have been received from branches not visited by him.

If answer is in negative or with qualification, the report shall state the reasons therefor.

Question 42

A company has a branch office which recorded a turnover of ₹ 1,90,000 in the financial year 2004-05. No audit of the branch has been carried out. The statutory auditor of the company has made no reference of the above branch in his report. The total turnover of the company is ₹ 10 crores for the year 2004-05. Comment. *(6 Marks, May, 2005)*

Answer

As per section 143(8) of the Companies Act, 2013 if a company has a branch office, the accounts of that office shall be audited either by the auditor appointed for the company (herein referred to as the company's auditor) under this Act or by any other person qualified for appointment as an auditor of the company under this Act and appointed as such under section 139, or where the branch office is situated in a country outside India, the accounts of the branch office shall be audited either by the company's auditor or by an accountant or by any other person duly qualified to act as an auditor of the accounts of the branch office in accordance with the laws of that country.

Therefore, the company has to get its branch audited. In case no branch audit has been carried out, company's auditor is required to mention this fact in the audit report and deal appropriately.

Question 43

What are your views on the following:

(a) *A Ltd. was under audit for the year ended 31.03.2004. An appeal filed by A Ltd. against the demand of Excise Duty of ₹ 26 crores was pending before the Supreme Court for which neither provision was made nor was disclosed in the notes to the financial statements. On 12th July, 2004, the auditor came to know through paper reports that the point involved in the appeal of A Ltd. was adjudicated by the Supreme Court in the case of some other assessee, which is in favour of the department of Excise Duty. The auditor insisted that provisions be made of ₹ 26 crores in the financial statements. The Management was of the view that since its own case is still pending, no provision is called for. It was also of the view that the event does not have any effect on the financial position of the company on the date of the Balance Sheet. Is the view of the Management tenable?*

(b) *Kevin Industries Ltd. has a paid up capital of ₹ 20 crores divided into equity shares of ₹ 10 each as on 31.03.2003. During the financial year 2003-04 it has issued bonus shares in the ratio 1 : 1. The net profit after tax for the years 31-03.2003 and 31.3.2004 is ₹ 10 crores and ₹ 15 crores respectively. The Earnings Per Share (EPS) disclosed in the financial statements for the above two years is ₹ 5.00 and ₹ 3.75 respectively. Is the disclosure correct?*

(c) *A firm of a father and a son is receiving ₹ 2 lakhs towards job work done for XYZ Ltd. during the year ended on 31.03.04. The total job work charges paid by XYZ Ltd. during the year are over ₹ 50 lakhs. The father is a Managing Director of XYZ Ltd. having substantial holding. The Managing Director told the auditor that since he is not involved in the activities of the firm and since the amount paid to it is insignificant; there is no need to disclose the transaction. He further contended that such a payment made in the last year was not disclosed. Is Managing Director right in his approach?*

(5 Marks each, November, 2004)

Answer

(a) Provision to be Provided For in the Financial Statement: As per AS 29 "Provisions, Contingent liabilities and Contingent Assets", a contingent liability is a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise.

Further, future events that may affect the amount required to settle an obligation should be reflected in the amount of a provision where there is sufficient objective evidence that the event will occur.

As per SA 570 “Going Concern”, there are certain examples of events or conditions that, individually or collectively, may cast significant doubt about the going concern assumption. Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy is one of the example of such event.

When the auditor concludes that the use of the going concern assumption is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether the financial statements adequately describe the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions; and disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it may be unable to realize its assets and discharge its liabilities in the normal course of business.

Since the issue involved in the appeal of A Ltd. was similar to the point in case of some other company and since the appeal of that company was decided against that company and in favour of the Excise Department, it is necessary for A Ltd. to make a provision of ₹ 26 crores as per AS 29. The case settled by the Supreme Court on similar point reflects significant developments affecting the assessment about the potential risk faced by the company. The view of the management that its own appeal is undecided or that it has no effect on the financial position as on 31.03.2004 is not at all tenable. Since the financial position is materially affected, the auditor should express a qualified opinion or an adverse opinion as may be appropriate.

(b) Disclosure of Earnings Per Share: AS 20 on Earning Per Share (EPS) prescribes principles for the determination and presentation of EPS. As per AS 20, the earnings per share have to be disclosed as basic and diluted earnings per share on the face of the Statement of Profit and Loss for each class of equity shares that has a different right to share in the net profit for the period. In the instant case, Kevin Industries Ltd., both the basic as well as the diluted earnings per share would be the same since there are no dilutive instruments that have been issued by the company. As per AS 20, in the case of a bonus issue, equity shares are issued to existing shareholders for no additional consideration and thus would lead to increase in number of equity shares without any adjustment to outstanding capital amount. Therefore, the number of equity shares outstanding is increased without an increase in resources. The standard further requires that the number of equity shares outstanding before the event of a bonus issue to be adjusted for the proportionate change in the number of equity shares outstanding as if the event had occurred at the beginning of the earliest period reported. Hence the EPS calculated as on 31-03-2003 would be Adjusted EPS and the same would be disclosed. In view of the above, the EPS will be calculated as under:

As on 31.03.2003

$$\frac{\text{Profits}}{\text{Adjusted No. of Shares}} = \text{Adjusted EPS}$$

$$\frac{10,00,00,000}{4,00,00,000} = ₹\ 2.5$$

As on 31.03.2004

$$\frac{\text{Profits}}{\text{No. of shares}} = \text{EPS}$$

$$\frac{15,00,00,000}{4,00,00,000} = ₹\ 3.75$$

Since the above figures of EPS have not been disclosed, Kevin Industries Ltd. has not complied with the provisions of AS 20. Therefore, the auditor would have to qualify his report in terms of section 143(3)(e) of the Companies Act, 2013.

(c) Related Party Disclosures: As per definition given in the AS 18 " Related Party Disclosures" parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions. Related party transaction means a transfer of resources or obligations between related parties, regardless of whether or not a price is charged.

In the instant case, the managing director of XYZ Ltd. is a partner in the firm with his son which has been paid ₹ 2 lakhs as job work charges. The managing director is having a substantial holding in XYZ Ltd. The case is squarely covered by AS 18. According to AS -18, in the case of related party transactions, the reporting enterprise should disclose the following:

(i) the name of the transacting related party;

(ii) a description of the relationship between the parties;

(iii) a description of the nature of transactions;

(iv) volume of the transactions either as an amount or as an appropriate proportion;

(v) any other elements of the related party transactions necessary for an understanding of the financial statements;

(vi) the amounts or appropriate proportions of outstanding items pertaining to related parties at the balance sheet date and provisions for doubtful debts due from such parties at that date; and

(vii) amounts written off or written back in the period in respect of debts due from or to related parties."

Further, SA 550 on "Related Parties", also prescribes the auditor's responsibilities and audit procedures regarding related party transactions.

The approach of the managing director is not tenable under the law and accordingly all disclosure requirements have to be complied with in accordance with the AS 18. Auditor should insist to make proper disclosure as per the AS and if management refuses, the auditor shall have to modify his report. Also it has to be seen whether section 184 of the Companies Act, 2013 regarding disclosure of interest by director has been complied with. If it is not complied with, the auditor needs to modify the report appropriately.

Question 44

Do you approve of the following? If not, why?

(a) Trimurthy Pan Masala (P) Ltd. was incurring heavy losses in the last several years since it could not withstand the competition in the market. The State in which the company had its registered office and also its major sales had moved a bill in the State Assembly to

ban manufacture and sale of all kinds of Pan Masalas in the State. While finalizing the accounts for the year ended 31-03-2004, the CFO of the company created a Deferred Tax Asset for the tax benefits that would arise in future years from the earlier years losses that had remained unabsorbed in Income Tax.

(b) *Big Ltd. has borrowed ₹ 30 lakhs from State Bank of India during the financial year 2003-04. The borrowings are used to invest in shares of Small Ltd., a subsidiary company of Big Ltd., which is implementing a new project estimated to cost ₹ 50 lakhs. As on 31st March, 2004, since the said project was not complete, the directors of Big Ltd. resolved to capitalize the interest accruing on borrowings amounting to ₹ 4 lakhs and add it to the cost of investments.* *(4 Marks each, November, 2004)*

Answer

(a) Creation of Deferred Tax Asset: Accounting Standard 22 on "Accounting for Taxes" requires that Deferred Tax Asset (DTA) should be recognised for all timing differences, subject to the considerations of prudence. The Standard further states that unabsorbed losses of the business can be considered for creation of DTA provided there is virtual certainty supported by convincing evidence that sufficient future taxable income will be available against which such DTA can be realised. In view of this, the DTA created by the CFO of Trimurthy Pan Masala (P) Ltd. is not in order. Since the company which is in the business of manufacturing of *panmasala* has been incurring heavy losses and in addition to this the State in which the company is having its major sales is proposing the ban on sale and manufacture of pan masala, the statutory auditor would, therefore, have to qualify his report and mention the extent of amounts of loss and reserves which are under and overstated respectively.

(b) Capitalisation of Interest: As per AS 13 on "Accounting for Investments", the cost of investment includes acquisition charges such as brokerage, fees and duties. In the instant case, Big Ltd. has used borrowed funds for purchasing shares of its subsidiary company Small Ltd. ₹ 4 lakhs interest payable by Big Ltd. to State Bank of India can not be called as cost of investment. The Accounting Standard 16 on "Borrowing Costs" also does not consider investment in shares as qualifying asset that can enable a company to add the borrowing costs to investments. In the instant case, the statutory auditor would qualify his report by stating that the borrowing costs have been wrongly added to the cost of investments rather than charging them to Statement of Profit and Loss. The effect of the same on the profits for the year would also have to be mentioned.

Question 45

Miranda Spinning Mills Ltd. is a sick company and has accumulated losses of ₹ 10 crores. The company has ₹ 12 crores in its share Premium Account. The Management desires to adjust the accumulated losses against the share premium balance. Advise the company giving your reasons. *(8 Marks, November, 2004)*

Answer

Application of Share Premium Account: Section 52 of the Companies Act, 2013 (herein after referred as the Act) deals with the application of premium received on issue of shares. Sub-section (1) of the said section provides that where a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount of the premium received on those shares shall be transferred to an account called "Securities Premium Account" and the provisions of this Act relating to reduction of share capital of a company except as provided in this section shall apply as if the securities premium account was the paid up share capital of the company. Sub-section (2) of the said section provides that notwithstanding anything contained in sub-section (1), securities premium account may be applied by the company for issue of bonus shares; writing off the preliminary expenses; writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company; in providing for the premium payable on redemption of any redeemable preference shares or any debentures of the company; for the purchase of its own shares or other securities. In view of these provisions of the Companies Act, 2013, it is not permitted to adjust its accumulated losses against the securities premium account.

Question 46

(a) Section 274 of the Companies Act, 1956 is applicable to appointment of Directors. Briefly explain your duty as a statutory auditor in this connection. (8 Marks, November, 2004)

(b) A company has paid interim dividend at 10% based on its half-yearly performance while at the end of the year suffered a net loss. How you will deal with the matter in your audit report as a statutory auditor? (4 Marks, November, 2004)

Answer

(a) This question is redundant in view of the provisions of the Companies Act, 2013.

(b) Declaration of Interim Dividend: Section 123 of the Companies Act, 2013 permits declaration of interim dividend during any financial year out of the surplus in the profit and loss account and out of profits of the financial year in which such interim dividend is sought to be declared. Ordinarily based on the performance of the company and taking a conservative view, the Board of Directors of the company declare the interim dividends. Quite often the advice of the auditor is sought before declaring an interim dividend. When this is done, he should suggest that an interim accounts should be prepared to ascertain the amount of profits that has been made. Assuming that interim accounts have been prepared and they disclose profits sufficient for the declaration of dividend after making appropriate provisions for depreciation, bad debts and other contingencies, only then the proportion of profits which have to be distributed as interim dividend may be decided.

Since the company has suffered a net loss at the end of the year, obviously the directors have miscalculated the performance of the company about the second half of the year. If the company had a sufficient balance in the profit and loss account as at the beginning of the year, the dividend declared could be paid out of the same. In such a case the auditor need not report anything. Moreover, if such balance was not available, the dividend could

also be paid out of the free reserves. The second proviso to Section 123(1) of the Companies Act, 2013 provides that, in the case of inadequacy or absence of profits in any year, dividends may be declared out of reserves. This can be done after the fulfilment of certain conditions as prescribed in Companies (Declaration and Payment of Dividend) Rules, 2014 like the rate of dividend declared shall not exceed the average of the rates at which dividend was declared by it in the three years immediately preceding that year; total amount to be drawn from such accumulated profits shall not exceed an amount equal to one-tenth of the sum of its paid-up share capital and free reserves as appearing in the latest audited financial statement; the balance of reserves after such withdrawal shall not fall below 15% of its paid-up share capital as appearing in the latest audited financial statement etc. If, however, there is no balance in the profit and loss account nor any reserves were available, the dividend would be clearly paid out of capital. The auditor would have to qualify his report mentioning the fact of the dividend having been paid out of capital.

Question 47

Write a short note on Responsibility of Joint Auditors. *(4 Marks, November, 2004)*

Answer

Responsibility of Joint Auditors: SA 299 on, "Responsibility of Joint Auditors" deals with the professional responsibilities which the auditors undertake in accepting such appointments as joint auditors. The responsibilities of joint auditors, as a rule are no different from the responsibilities of individual auditors as enumerated in the Companies Act. Main features of the said SA are discussed below:

- *Division of Work:* Where joint auditors are appointed, they should, by mutual discussion, divide the audit of identifiable units or specified areas. Certain areas of work, owing to their importance or owing to the nature of work involved would not be divided and would be covered by all the joint auditors. Such a division affected by the joint auditors should be adequately documented and preferably communicated to the auditee.
- *Coordination:* Where in the course of his work, a joint auditor comes across matters which are relevant to the areas of other joint auditors and which require joint discussion, he should communicate the same to all the other joint auditors in writing before the finalisation of audit and preparation of audit report.

In respect of the work divided amongst the joint auditors, each joint auditor is responsible only for the work allocated to him, whether or not he has made a separate report on the work performed by him. On the other hand the joint auditors are jointly and severally responsible in respect of the audit conducted by them as under:

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

(b) 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.

(c) 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;

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

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

(f) It is the separate and specific responsibility of each joint auditor to study and evaluate the prevailing system of internal control relating to the work allocated to him, the extent of enquiries to be made in the course of his audit.

(g) The responsibility of obtaining and evaluating information and explanation from the management is generally a joint responsibility of all the auditors.

(h) Each joint auditor is entitled to assure that the other joint auditors have carried out their part of work in accordance with the generally accepted audit procedures and therefore it would not be necessary for joint auditor to review the work performed by other joint auditors.

Normally, the joint auditors are able to arrive at an agreed report. However where the joint auditors are in disagreement with regard to any matters to be covered by the report, each one of them should express his own opinion through a separate report. A joint auditor is not bound by the views of majority of joint auditors regarding matters to be covered in the report and should express his opinion in a separate report in case of a disagreement.

Question 48

In the books of accounts of M/s OPQ Ltd. huge differences are noticed between the control accounts and subsidiary records. The Chief Accountant informs that this is common due to huge volume of business done by the company during the year. As a Statutory Auditor, how would you deal? *(4 Marks, May, 2004)*

Answer

Difference between Control Accounts and Subsidiary Records: The huge differences found between control accounts and subsidiary records in the books of M/s OPQ Ltd. indicate that there may be material misstatements requiring detailed examination by the auditor to ascertain the cause. The contention of Chief Accountant cannot be accepted simply because the company has done huge volume of business. Such a phenomenon indicates that recording of transactions is not being done properly or the accounting system in the company which might have several branches spread over the country fails to capture all transactions in time. It would also be interesting to see whether it is a recurring phenomenon or such reconciliation could not be done at a subsequent date. Having regard to all these circumstances, it appears from the facts of the case that these differences indicate the possibility of some kind of material misstatements. As per SA 240, "The Auditor's Responsibilities relating to Fraud in an Audit of Financial Statements", when the auditor identifies a misstatement, the auditor shall evaluate whether such a misstatement is indicative of fraud. If there is such an indication, the auditor shall evaluate the implications of the misstatement in relation to other aspects of the audit, particularly the reliability of management representations, recognizing that an instance of fraud is unlikely to be an isolated occurrence. When the auditor confirms that, or is unable to conclude whether, the financial

statements are materially misstated as a result of fraud the auditor shall evaluate the implications for the audit.

Question 49

State the salient features of Investor's Education and Protection Fund. (8 Marks, May, 2004)

Answer

Salient Features of Investors Education and Protection Fund: Section 205C of the Companies Act, 1956 empowers the Central Government to establish a fund to be called the Investor Education and Protection Fund to be utilized for the promotion of investor awareness and protection of the interest of the investors. The following amounts shall be credited to the fund, namely,

(a) amounts in unpaid dividends accounts of companies;

(b) matured deposits with companies;

(c) application moneys received by companies for allotment of any securities and due for refund;

(d) matured debentures with companies;

(e) interest, if any, accrued on the above items, i.e. (a) to (d);

(f) grants and donations given to the Fund by the Government or any other institutions, etc.

(g) the interest or other incomes received out of the investments made from the fund.

It may be noted that in respect of four items, i.e., unpaid dividends, application moneys, matured deposits and debentures shall be transferred to Fund only if such amounts shall remained unclaimed and unpaid for seven years from the date they became due for payment.

In fact, after lapses of seven years, no claims are tenable against the company or the Fund.

(Note - The answer to this question would be based on provisions of Section 125 of the Companies Act, 2013 which is yet to be notified.)

Question 50

Write short explanatory notes on the following:

(a) Treatment of foreign currency monetary items on balance sheet date.

(b) Areas of propriety audit under Section 227(1A) of the Companies Act, 1956.

(4 Marks each, May, 2004)

Answer

(a) Foreign Currency Monetary Items and its Treatment on Balance Sheet Date: As per AS 11 on "The Effects of Changes in Foreign Exchange Rates" monetary items are money held and assets and liabilities to be received or paid in fixed or determinable amounts of money, e.g., cash, receivable, payables, etc. Regarding foreign currency transactions, AS 11 requires that while reporting effects of changes in exchange rates

subsequent to initial recognition, at each balance sheet date, monetary items denominated in a foreign currency, (e.g., foreign currency notes, balances in bank accounts denominated in a foreign currency, and receivables, payables and loans denominated in a foreign currency) should be reported using the closing rate prevailing on balance sheet date. However in certain circumstances the closing rate may not reflect, with reasonable accuracy, the amount in reporting currency that is likely to be realized from or required to be disbursed to because the rate is unrealistic. In such circumstances, the relevant monetary item should be reported in the reporting currency at the amount which is likely to be realized from or required to be disbursed to at the balance sheet date.

(b) This question is redundant in view of the provisions of the Companies Act, 2013.