PAPER – 1 : ACCOUNTING

Answer all questions.

Working notes should form part of the answer.

Question 1

A, B and C carried on business in partnership, sharing Profits and Losses in the ratio of 1:2:3. They decided to form a private limited company, AB (P) Ltd. and C is not interested to take over the shares in AB (P) Ltd. The authorized share capital of the company is Rs.12,00,000 divided into 12,000 ordinary shares of Rs.100 each.

The company was incorporated and took over goodwill as valued and certain assets of the partnership firm on 31.3.2006. The Balance Sheet of the partnership firm on that date was as follows:

Liabilities		Rs.	Assets	Rs.
Capital Accounts:			Fixed Assets:	
A		1,00,000	Machinery	1,20,000
B		2,00,000	Land	1,74,000
C		3,00,000	Motorcycles	30,000
Current Accounts:			Furniture & fittings	11,000
A		39,420	Current Assets:	
B		60,580	Stock	2,35,000
A's Loan A/c	28,000		Debtors	43,000
(+) Interest accrued	2,000	30,000	Cash in hand	87,000
Current Liability:			C's overdrawn	1,00,000
Creditors		70,000		
		8,00,000		8,00,000

C, who retired was presented by the other partners (A and B) with one motorcycle valued in the books of the firm Rs.9,000. The remaining motorcycles were sold in the open market for Rs.13,000. C also received certain furniture for which he was charged Rs.2,000. The debtors which were all considered good, were taken over by C for Rs.40,000. A and B were charged in their profit sharing ratio for the book value of Motorcycle presented by them to C.

It was agreed that C who is not willing to take the shares in AB (P) Ltd. was discharged first by providing necessary cash. A and B should bring cash, if necessary.

AB (P) Ltd. took over the remaining furniture and fittings at a price of Rs.13,000, the machinery for Rs.1,25,000, the stock at an agreed value of Rs.2,00,000 and the land at its book value. The value of the goodwill of the partnership firm was agreed at Rs.88,000. The creditors of the firm were settled by the firm for Rs.70,000. A's loan account together with interest accrued was transferred to his capital account.

The purchase consideration was discharged by the company by the issue of equal number of fully paid up equity shares at par to A and B.

Prepare Realisation A/c, Capital A/cs of the partners and Cash A/c. Also draw the Balance Sheet of AB (P) Ltd. (20 Marks)

Answer

Realization Account

Dr.		Rs.		Cr.	Rs.
To	Machinery	1,20,000	By	Creditors	70,000
To	Land	1,74,000	By	AB (P) Ltd. – Purchase consideration (Refer Working Note)	6,00,000
To	Motor Cycles	30,000	By	A's Capital A/c	3,000
To	Furniture & Fittings	11,000	By	B's Capital A/c	6,000
To	Stock	2,35,000	By	C's Capital A/c (2,000 + 40,000)	42,000
To	Debtors	43,000	By	Cash A/c (Sale of Motor Cycle)	13,000
To	Cash (payment to creditors)	70,000			
To	Profit transferred to				
	A's Capital A/c	8,500			
	B's Capital A/c	17,000			
	C's Capital A/c	25,500			
		7,34,000			7,34,000

Partners' Capital Accounts

Dr		A	B	C		Cr.	A	B	C
		Rs.	Rs.	Rs.			Rs.	Rs.	Rs.
To	Current A/c	-	-	1,00,000	By	Balance b/d	1,00,000	2,00,000	3,00,000
To	Realisation A/c (Assets taken over)	3,000	6,000	42,000	By	Current A/c	39,420	60,580	-
To	Equity shares in AB (P) Ltd.	3,00,000	3,00,000	-	By	A's Loan A/c	30,000	-	-
To	Cash A/c	-	-	1,83,500	By	Realization A/c (Profit)	8,500	17,000	25,500
					By	Cash A/c	1,25,080	28,420	
		3,03,000	3,06,000	3,25,500			3,03,000	3,06,000	3,25,500

Cash Account

Dr.		Rs.			Cr. Rs.
To	Balance b/d	87,000	By	Realisation A/c	70,000
To	Realisation A/c	13,000	By	C's Capital A/c	1,83,500
To	A's Capital A/c	1,25,080			
To	B's Capital A/c	28,420			
		2,53,500			2,53,500

Balance Sheet of AB (P) Ltd.

Liabilities	Rs.	Assets	Rs.
Authorised Share Capital:		Fixed Assets:	
12,000 Equity Shares of Rs.100 each	12,00,000	Goodwill	88,000
		Land	1,74,000
Issued, Subscribed & Paid up:		Machinery	1,25,000
6,000 equity shares of Rs.100 each fully paid up (shares were issued for consideration otherwise than for cash)	6,00,000	Furniture & Fittings	13,000
		Current Assets:	
		Stock	2,00,000
	6,00,000		6,00,000

Working Note:

Calculation of Purchase Consideration

Assets taken over by AB (P) Ltd.	Rs.
Machinery	1,25,000
Furniture & Fittings	13,000
Land	1,74,000
Stock	2,00,000
Goodwill	88,000
Purchase Consideration	6,00,000

Purchase consideration is discharged by the issue of equal number of equity shares of Rs.100 each (3,000 shares) at par to A & B.

Question 2

The following is the Balance sheet of Weak Ltd. as on 31.3.2006:

Liabilities	Rs.	Assets	Rs.
Equity shares of Rs.100 each	1,00,00,000	Fixed assets	1,25,00,000
12% cumulative preference shares of Rs.100 each	50,00,000	Investments (Market value Rs.9,50,000)	10,00,000
10% debentures of Rs.100 each	40,00,000	Current assets	1,00,00,000
Sundry creditors	50,00,000	P & L A/c	4,00,000
Provision for taxation	1,00,000	Preliminary expenses	2,00,000
	2,41,00,000		2,41,00,000

The following scheme of reorganization is sanctioned:

(i) All the existing equity shares are reduced to Rs.40 each.

(ii) All preference shares are reduced to Rs.60 each.

(iii) The rate of interest on debentures is increased to 12%. The debentureholders surrender their existing debentures of Rs.100 each and exchange the same for fresh debentures of Rs.70 each for every debenture held by them.

(iv) One of the creditors of the company to whom the company owes Rs.20,00,000 decides to forgo 40% of his claim. He is allotted 30,000 equity shares of Rs.40 each in full satisfaction of his claim.

(v) Fixed assets are to be written down by 30%.

(vi) Current assets are to be revalued at Rs.45,00,000.

(vii) The taxation liability of the company is settled at Rs.1,50,000.

(viiii) Investments to be brought to their market value.

(ix) It is decided to write off the fictitious assets.

Pass Journal entries and show the Balance sheet of the company after giving effect to the above. (16 Marks)

Answer

Journal Entries in the books of Weak Ltd.

			Rs.	Rs.
(i)	Equity share capital (Rs.100) A/c	Dr.	1,00,00,000	
	To Equity Share Capital (Rs.40) A/c			40,00,000
	To Capital Reduction A/c			60,00,000
	(Being conversion of equity share capital of Rs.100 each into Rs.40 each as per reconstruction scheme)			

(ii)	12% Cumulative Preference Share capital (Rs.100) A/c	Dr.	50,00,000	
	To 12% Cumulative Preference Share Capital (Rs.60) A/c			30,00,000
	To Capital Reduction A/c			20,00,000
	(Being conversion of 12% cumulative preference share capital of Rs.100 each into Rs.60 each as per reconstruction scheme)			
(iii)	10% Debentures A/c	Dr.	40,00,000	
	To 12% Debentures A/c			28,00,000
	To Capital Reduction A/c			12,00,000
	(Being 12% debentures issued to 10% debenture-holders for 70% of their claims. The balance transferred to capital reduction account as per reconstruction scheme)			
(iv)	Sundry Creditors A/c	Dr.	20,00,000	
	To Equity Share Capital A/c			12,00,000
	To Capital Reduction A/c			8,00,000
	(Being a creditor of Rs.20,00,000 agreed to surrender his claim by 40% and was allotted 30,000 equity shares of Rs.40 each in full settlement of his dues as per reconstruction scheme)			
(v)	Provision for Taxation A/c	Dr.	1,00,000	
	Capital Reduction A/c	Dr.	50,000	
	To Liability for Taxation A/c			1,50,000
	(Being conversion of the provision for taxation into liability for taxation for settlement of the amount due)			
(vi)	Capital Reduction A/c	Dr.	99,50,000	
	To P & L A/c			4,00,000
	To Preliminary Expenses A/c			2,00,000
	To Fixed Assets A/c			37,50,000
	To Current Assets A/c			55,00,000
	To Investments A/c			50,000
	To Capital Reserve A/c			50,000
	(Being amount of Capital Reduction utilized in writing off P & L A/c (Dr.) Balance, Preliminary Expenses, Fixed Assets, Current Assets, Investments and the Balance transferred to Capital Reserve)			

(vii)	Liability for Taxation A/c	Dr.	1,50,000	
	To Current Assets (Bank A/c)			1,50,000
	(Being the payment of tax liability)			

Balance Sheet of Weak Ltd. (and reduced) as on 31.3.2006

Liabilities	Rs.	Assets	Rs.
Issued, subscribed and paid up capital: 1,30,000 equity shares of Rs.40 each	52,00,000	Fixed Assets (1,25,00,000 – 37,50,000)	87,50,000
12% Cumulative Preference Shares of Rs. 60 each	30,00,000	Investments (10,00,000 – 50,000)	9,50,000
Reserves & Surplus: Capital Reserve	50,000	Current Assets (45,00,000 – 1,50,000)	43,50,000
Secured Loan: 12% Debentures	28,00,000		
Current Liabilities and Provisions:			
Sundry Creditors: (50,00,000 – 20,00,000)	30,00,000		
	1,40,50,000		1,40,50,000

Working Note:

Capital Reduction Account

	Rs.		Rs.
To Liability for taxation A/c	50,000	By Equity share capital	60,00,000
To P & L A/c	4,00,000	By 12% Cumulative preference share capital	20,00,000
To Preliminary expenses	2,00,000	By 10% Debentures	12,00,000
To Fixed assets	37,50,000	By Sundry creditors	8,00,000
To Current assets	55,00,000		
To Investment	50,000		
To Capital Reserve (balancing figure)	50,000		
	1,00,00,000		1,00,00,000

Question 3

Red and Co. of Mumbai started a branch at Bangalore on 1.4.2006 to which goods were sent at 20% above cost. The branch makes both cash sales and credit sales. Branch expenses are met from branch cash and balance money remitted to H.O. The branch does not maintain double entry books of account and necessary accounts relating to branch are maintained in H.O. Following further details are given for the year ending on 31.3.2007:

	Rs.
Cost of goods sent to branch	1,00,000
Goods received by branch till 31.3.2007 at Invoice price	1,08,000
Credit sales for the year	1,16,000
Closing debtors on 31.3.2007	41,600
Bad debts written off during the year	400
Cash remitted to H.O.	86,000
Closing cash on hand at branch on 31.3.2007	4,000
Cash remitted by H.O. to branch during the year	6,000
Closing stock in hand at branch at invoice price	12,000
Expenses incurred at branch	24,000

Draw up the necessary Ledger Accounts like Branch Debtors Account, Branch Stock Account, Goods sent to Branch Account, Branch Cash Account, Branch Expenses Account and Branch Adjustment A/c for ascertaining gross profit and Branch Profit and Loss A/c for ascertaining Branch profit. (16 Marks)

Answer

Branch Debtors A/c

Dr.		Rs.		Cr.	Rs.
To	Branch Stock A/c	1,16,000	By	Branch Cash A/c (balancing figure)	74,000
			By	Bad Debts (written off)	400
			By	Balance c/d	41,600
		1,16,000			1,16,000

Goods Sent to Branch A/c

		Rs.			Rs.
To	Branch Adjustment A/c $1,00,000 \times \frac{20}{100}$	20,000	By	Branch Stock A/c	1,20,000
To	Purchases/ Trading A/c	1,00,000			
		1,20,000			1,20,000

Branch Cash A/c

To	Branch Debtors A/c	74,000	By	Branch Expenses A/c	24,000
To	H.O. A/c (cash remittance)	6,000	By	H.O. (cash remittance)	86,000
To	Branch Stock A/c		By	Balance c/d	4,000
	- Cash Sales (balancing figure)	34,000			
		1,14,000			1,14,000

Branch Stock A/c

To	Goods sent to Branch A/c	1,20,000	By	Branch Debtors A/c	1,16,000
To	Branch Adjustment A/c	54,000	By	Branch Cash A/c (Sales)	34,000
	(Excess profit over normal loading - balancing figure)		By	Goods in Transit (1,20,000-1,08,000)	12,000
			By	Balance c/d	12,000
		1,74,000			1,74,000

Branch Expenses A/c

To	Branch Cash A/c	24,000	By	Branch P&L A/c	24,000

Branch Adjustment A/c

To	Stock Reserve A/c	2,000	By	Goods sent to Branch A/c	20,000
To	Goods in transit Reserve A/c	2,000	By	Branch Stock A/c	54,000
To	Branch P&L A/c (Balancing figure)	70,000			
		74,000			74,000

Branch P & L A/c

To	Branch Expenses A/c	24,000	By	Branch Adjustment A/c	70,000
To	Bad Debts	400			
To	Net Profit (transferred to General P&L A/c)	45,600			
		70,000			70,000

Working Notes:

1. Loading is 20% of cost i.e. 16.67% (1/6th) of invoice value.

   Loading on closing stock = Rs. 1/6th of Rs.12,000 =Rs. 2,000.

2. Loading on goods sent to branch = 1/6th of Rs.1,20,000 = Rs. 20,000.

3. Loading on goods in transit = 1/6th of Rs. 12,000 = Rs. 2,000.

Question 4

(a) From the following information of details of advances of X Bank Limited calculate the amount of provisions to be made in profit and loss account for the year ended 31.3.2007:

Asset classification	Rs. in lakhs
Standard	6,000
Sub-standard	4,400
Doubtful:	
For one year	1,800
For two years	1,200
For three years	800
For more than three years	600
Loss assets	1,600

(b) X Electricity Company Limited decides to replace one of its old plants with a modern one in April, 2006. The plant when installed in the year 2000, costed the company Rs.26 lakhs, the components of materials and labour being in the ratio of 7:3. It is ascertained that the cost of labour and materials have risen by 30% and 25% respectively. The cost of new plant is Rs.66 lakhs and in addition old materials worth Rs.92,000 are reused. Old materials worth Rs.1,68,000 are sold. Under double account system compute the following:

(i) The amount to be written off to Revenue A/c.

(ii) The amount to be capitalized.

(iii) Draw up the necessary Journal entries.

(iv) Draw up the Replacement Account. (6 + 10 Marks)

Answer

(a) Statement showing provisions on various performing and non-performing assets

Asset Classification	Amount	Provision	Amount of Provision
	Rs. in Lakhs	%	Rs. in lakhs
Standard	6,000	0.40	24
Sub-standard**	4,400	10	440
Doubtful**			
One year	1,800	20	360
2 years	1,200	30	360

** Sub standard and doubtful assets have been treated as fully secured.

3 years	800	30	240
More than 3 years	600	100*	600
Loss assets	1,600	100	1,600
			3,624

(b) (i) Statement showing amount to be written off to Revenue Account

			Rs.
Cost of old plant			26,00,000
Add:.	Increase in cost of material	$26,00,000x \frac{7}{10}\times\frac{25}{100}$	4,55,000
	Increase in cost of Labour	$26,00,000 \text{ x } \frac{3}{10}\times\frac{30}{100}$	2,34,000
	Current cost of old plant		32,89,000
Less:	Cost of Material used	92,000	
	Cost of Material sold	1,68,000	(-) 2,60,000
Amount to be written off to Revenue A/c			30,29,000

(ii) Statement showing amount to be capitalised

Cost of new plant excluding the value of old materials used	66,00,000
Less: Current cost of old plant	32,89,000
Current cost to be capitalized	33,11,000
Add: Value of old material used	92,000
Total amount to be capitalized	34,03,000

(iii) Journal Entries in the Books of X Electricity Company Ltd.

			Rs.	Rs.
(a)	Replacement Account	Dr.	32,89,000	
	To Bank Account			32,89,000
	(Being the replacement of old plant by a new plant; the current cost of replacement Rs.32,89,000)			
(b)	Plant Account	Dr.	34,03,000	
	To Replacement Account			92,000
	To Bank Account			33,11,000

* w.e.f. 31st March 2007

	(Being additional cost of new plant capitalized and also old materials used in construction of new plant)			
(c)	Bank Account	Dr.	1,68,000	
	To Replacement A/c			1,68,000
	(Being the sale of old materials for Rs.1,68,000)			
(d)	Revenue A/c	Dr.	30,29,000	
	To Replacement Account			30,29,000
	(Being the balance of replacement account transferred to revenue account)			

(iv) Replacement Account

Dr.					Cr.
		Rs.			Rs.
To	Bank A/c	32,89,000	By	New Plant A/c	92,000
			By	Bank A/c	1,68,000
			By	Revenue A/c (Balancing figure)	30,29,000
		32,89,000			32,89,000

Question 5

Mr. A is insolvent. He supplies to you the following information as on 31.3.2006:

	Rs.
Cash in hand	10,000
Creditors for goods	10,00,000
Taxes due to Government	35,000
Bank loan secured by lien on stock	1,50,000
Furniture (expected to realize Rs 50,000)	75,000
Stock (expected to realize 50%)	6,00,000
Book debts (good)	4,50,000
Book debts (doubtful) expected to realize 40%	5,50,000
Bills discounted (Rs.40,000 bad)	1,40,000
Loan from Nathan secured by second charge on stock	2,00,000

Bills receivable (Rs.40,000 bad) 1,00,000

Mr. A started business four years ago with a capital of Rs.4,50,000. He drew Rs.75,000 each year for private purposes, but did not maintain proper books of accounts. Mrs. A gave up her jewellery valued Rs.1,00,000 to the receiver.

Prepare Statement of Affairs of Mr. A as on 31.3.2006 and Deficiency Account as on that date.

(16 Marks)

Answer

Statement of Affairs of Mr. 'A' as on 31.3.2006

Gross Liabilities	Liabilities		Expected to Rank	Property & Assets	Book Value	Expected to produce
Rs.		Rs.			Rs.	Rs.
11,40,000	Unsecured creditors as per list A		10,40,000	Properties as per list E :		
1,50,000	Fully Secured Creditors			Cash in Hand	10,000	10,000
	as per List B (Bank Loan)	1,50,000		Furniture	75,000	50,000
	Less: Estimated value of stock	3,00,000		Jewellery from wife	-	1,00,000
		1,50,000		Book debts as per List F:		
	Surplus transferred to List C	1,50,000	-			
2,00,000	Partly secured creditors as per List C (Loan from Nathan)	2,00,000		Good	4,50,000	4,50,000
	Surplus transferred from List B	1,50,000	50,000	Doubtful	5,50,000	2,20,000
35,000	Preferential creditors as per list D (Taxes due to Government)	35,000		Bills Receivable as per List G	1,00,000	60,000
	Deducted as per contra	35,000	-		11,85,000	8,90,000
				Less: Preferential creditors as per contra		35,000
						8,55,000
				Deficiency as explained in List H		2,35,000
15,25,000			10,90,000			10,90,000

Deficiency Account (List H)

	Rs.		Rs.	Rs.
Excess of Assets over Liabilities	4,50,000	Bad debts as per List F		3,30,000
Accumulated Profit up to 31st March, 2006 (Refer Working Note 2)	2,50,000	Drawings (75,000x4)		3,00,000
		Other Losses:		
Profit from other sources: Jewellery from wife	1,00,000	Loss on realization of Furniture	25,000	
Deficiency as per Statement of Affairs	2,35,000	Stock	3,00,000	
		Bills receivable	40,000	3,65,000
		Loss on Bills Discounted		40,000
	10,35,000			10,35,000

Working Notes:

1. Calculation of unsecured creditors as per List A

	Gross	Expected to Rank
	Rs.	Rs.
Creditors for Goods	10,00,000	10,00,000
Liabilities for Bills Discounted	1,40,000	40,000
	11,40,000	10,40,000

2. Calculation of Accumulated Profit/Loss

Trial Balance

Debit	Rs.	Credit	Rs.
Cash	10,000	Creditors	10,00,000
Furniture	75,000	Taxes due to Government	35,000
Stock	6,00,000	Bank Loan	1,50,000
Debtors (4,50,000 + 5,50,000)	10,00,000	Loan from Nathan	2,00,000
Bills Receivable	1,00,000	Capital	4,50,000
Drawings (75,000 x 4)	3,00,000	Accumulated Profit (b/f)	2,50,000
	20,85,000		20,85,000

Question 6

Answer any four of the following:

(a) What are the disclosure requirements of AS-7 (Revised)?

(b) How would you treat the Government grant received relating to a depreciable asset under the following cases as per AS-12?

Case i: Gross value of asset Rs.2 crores and Grant received Rs.20 lakhs only.

Case ii: Gross value of asset Rs.2 crores and Grant received Rs.2 crores.

(c) Explain the concept of actuarial valuation.

(d) What are the information that are extracted from the well designed accounting system in Agricultural Farm?

(e) Write a short note on 'B' List contributories under Liquidation of a company.

(d) What are the information that are to be disclosed in the financial statements as per AS-10? (4x4= 16 Marks)

Answer

(a) According to paragraphs 38, 39 and 41 of AS 7, an enterprise should disclose:

(a) the amount of contract revenue recognized as revenue in the period;

(b) the methods used to determine the contract revenue recognized in the period; and

(c) the methods used to determine the stage of completion of contracts in progress.

In case of contract still in progress the following disclosures are required at the reporting date:

(a) the aggregate amount of costs incurred and recognised profits (less recognised losses) upto the reporting date;

(b) the amount of advances received; and

(c) the amount of retentions.

An enterprise should also present:

(a) the gross amount due from customers for contract work as an asset; and

(b) the gross amount due to customers for contract work as a liability.

(b) In accordance with AS 12, government grants related to specific fixed assets should be presented in the balance sheet by showing the grant as a deduction from the gross value of the assets concerned in arriving at their book value. Where the grant related to a specific fixed asset equals the whole, or virtually the whole, of the cost of the asset, the asset should be shown in the balance sheet at a nominal value.

Alternatively, government grants related to depreciable fixed assets may be treated as deferred income which should be recognized in the profit and loss statement on a systematic and rational basis over the useful life of the asset, i.e., such grants should be allocated to income over the periods and in the proportions in which depreciation on those assets is charged.

Case i

Grant received amounting Rs.20 lakhs is required to be deducted from Rs.2 crores. The balance of Rs.1.80 crores to be shown as an assest in the Balance Sheet and depreciation should also be charged on Rs.1.80 crores.

Case ii

As the grant is received for the entire cost of the asset, the asset shall be recorded at a nominal value of Rs.100 in the Balance sheet so that the existence of the amount is reflected. No depreciation is to be charged in this case.

Note: Alternatively, in both the cases government grant may be treated as deferred income which should be recognized in the profit and loss statement on a systematic and rational basis over the useful life of the asset.

(c) Actuarial valuation is the process used by an actuary* to estimate the present value of benefits to be paid under a retirement scheme and the present values of the scheme assets and, sometimes, of future contributions. In the case of defined benefit scheme the cost of retirement benefits, to be charged to Profit and Loss Account on year to year basis, is determined on actuarial basis. According to paragraph 65 of AS 15 (revised 2005), an enterprise should use the Projected Unit Credit**method to determine the present value of its defined benefit obligations and the related current service cost and, wherever applicable, past service cost.

(d) A well designed accounting system can be used for extracting the following information:

1. Crop-wise performance and overall performance of the agricultural enterprise.
2. Comprehensive information regarding yield, revenue, input and cost of the enterprise.
3. Financial state of affairs i.e. assets and liabilities of the farm at a particular point of time.
4. Profit/Loss of the farm during a year.
5. Data base for other decisions, namely (a) acquire assets or hire services for ploughing, irrigation, weeding, threshing etc.; (b) replacement of draught animal, machinery and farming technique; (c) selection of crop-mix; (d) choosing farm size; (e) farm diversification, for example adding crop and non-farming activities like processing of agricultural products; (f) divestment decisions whether to discontinue agricultural operations.
6. Supporting data to the lenders including banks and co-operative societies to assess farm's financial requirements as well as debt servicing ability.
7. Reliable data for farm management survey.
8. Reliable data for assessment of agricultural income tax.

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* Actuary is an expert person who can calculate the liability where the factors affecting the calculation of liability are uncertain and cannot be determined in ordinary course.

** Projected Unit Credit method (sometimes known as the accrued benefit method pro-rated on service or as the benefit/years of service method) considers each period of service as giving rise to an additional unit of benefit entitlement and measures each unit separately to build the final obligation.

(e) The shareholders who transferred partly paid shares (otherwise than by operation of law or by death) within one year, prior to the date of winding up may be called upon to pay an amount (not exceeding the amount not called up when the shares were transferred) to pay off such creditors as existed on the date of transfer of shares. Such shareholders are called B List Contributories. Their liability will crystallize only (i) when the existing assets available with the liquidator are not sufficient to cover the liabilities; (ii) when the existing shareholders fail to pay the amount due on the shares to the liquidator.

(f) As per AS 10, the following information should be disclosed in the financial statements :

(i) gross and net book values of fixed assets at the beginning and end of an accounting period showing additions, disposals, acquisitions and other movements ;

(ii) expenditure incurred on account of fixed assets in the course of construction or acquisition ; and

(iii) revalued amount substituted for historical costs of fixed assets, the method adopted to compute the revalued amounts, the nature of indices used, the year of any appraisal made, and whether an external valuer was involved, in case where fixed assets are stated at revalued amounts.

PAPER – 2 : AUDITING

Answer Question Nos. 1 and 2 and any four questions from the rest.

Question 1

As an auditor, comment on the following :

(a) You are a Principal Auditor of Sri Company Limited which has three branches the accounts of which are subject to audit by qualified branch auditors. One of the branch auditors qualified his report for non-provision of doubtful debts which he considered to be material for the company as a whole. Subsequent to their reporting, but before you could sign the audit report on the accounts of the company as a whole, the management informed you that the debt under the subject-matter of qualification in Branch Auditor's report had been fully recovered. (5 Marks)

(b) A Ltd. is a holding company of B Ltd. B Ltd. is going to start a new project estimated to cost Rs. 20 crores. For this A Ltd. made an investment of Rs. 10 crores in the shares of B Ltd. by borrowing the same from financial institution @10% p.a. As on 31st March, 2005 the project was not completed. The Directors of A Ltd. want to capitalize the interest upto 31st March, 2005 on borrowings amounting to Rs. 1 crore and add it to the cost of investments. (5 Marks)

(c) A contractor entered into a contract for building roads for Rs. 2 crores. After completing 60% of the contract he came to know that the cost of completing the contract would be Rs. 2.40 crores. The accountant transferred Rs 0.24 crores i.e., 60% of total loss of Rs. 0.40 crores to Profit and Loss account in the current year. (5 Marks)

(d) Finished goods costing worth Rs. 10 lacs were damaged due to floods in July, 2004. These goods were included in the closing stock as on March 31, 2005 at an estimated realisable value of Rs. 4 lacs. These goods, ultimately, could be sold for Rs. 3 lacs only in the accounting year 2005-06. The difference of Rs. 1 lac was debited to prior period expenditure in the accounting year 2005-06. (5 Marks)

Answer

(a) Qualification in branch auditor's report-subsequent events: The Branch auditor had qualified on non-provision of a major debt. After his report but before the issue of report by Principal auditor an event happened which has thrown new light on the facts that existed as on the date of balance sheet date. This is a subsequent event within the meaning of AAS 19 i.e. event that had taken place between the date of balance sheet date and the date of signing the audit report. In relation to the cases where the component (i.e. branch) is audited by another auditor, the subsequent event would include events that had taken place between the date of audit report of the component and the date of signing the audit report of the entity as a whole by the principal auditor. On becoming aware of the subsequent events, the auditor should consider whether the accounts had been drawn so as to give effect to the facts of subsequent events. Accordingly, the auditor should omit qualification as the debt is no more doubtful in view of its recovery in full. However, the auditor may check that it has in fact been received by a substantial vouching of the subsequent events which had been considered by him to make himself fully satisfied about his report in the matter.

(b) Capitalisation of interest on borrowing cost : AS-16 states that borrowing cost that are directly attributable to the acquisition, construction or production of a qualifying asset, should be capitalized as a part of the cost of that asset. Qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale, e.g. manufacturing plants, power generation facilities etc. that require a substantial period of time to bring them to a saleable condition.

In the given case interest of Rs. 1 crore should not be capitalized because as per AS-16

(a) Investment of Rs. 10 crores in the shares of B Ltd. By A Ltd. is not a qualifying asset.

(b) Only borrowing cost incurred upto acquisition is allowed to be capitalized which would be nil in the case of investments.

Therefore the intention of company is wrong. As an auditor it should be brought to the knowledge of management and interest of Rs. 1 crore should be shown as an expenditure in profit & Loss a/c.

(c) Recognition of Contract Revenue & Expenditure : As per AS-7 when it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognized as an expense immediately irrespective of the stage of completion.

In the given case the revenue that can be recognized for the contract i.e. Rs. 2 crore and the expected expense on the contract is Rs. 2.4 cores. 60% of the contract has been completed. Therefore as per AS-7 whole amount of expected loss i.e. Rs.0.40 crores should be recognized as an expense immediately irrespective of the stage of completion of the contract.

Therefore the action of accountant of transferring only Rs. 0.24 crores to the profit & loss a/c is wrong. He must transfer whole Rs. 0.40 crore to profit & loss a/c as an expense.

Auditor must advice the accountant to rectify the same and if he fails to do so he should qualify his report.

(d) Prior Period Items: As per AS 5 "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."

Prior Period items should be distinguished from changes in accounting estimates. Accounting estimates by their nature are approximations that may need revision as additional information become known or the transaction is finally settled.

In the instant case there is no error or omission in prior periods. It is a case of accounting estimates which have changed when the damaged goods have been finally sold.

Thus the difference of Rs. 1 Lac, debited to prior period expenditure in the accounting year 2005-06 is a wrong accounting treatment.

Question 2

(a) Give your comments on the following:

(i) M/s A & Co., Chartered Accountants, were appointed first auditors of KLM Ltd. By its Board of Directors. The shareholders of the company removed M/s A & Co. before the expiry of their term, by an ordinary resolution in an Extraordinary General Meeting and appointed another auditors in their place. M/s A & Co. have objected that without prior approval of Central Government their removal is illegal. (4 Marks)

(ii) The Articles of Association of ABC Ltd. do not authorise the company to buy back its own shares. However, a special resolution has been passed in general meeting of the company authorising the buy-back. The Directors of the company are of the opinion that even without authority in the Articles of Association the buy-back is possible due to special resolution passed in the general meeting authorizing the buy-back. (4 Marks)

(b) W Ltd. approached SB & Co. a leading firm of Chartered Accountants having two partners S & B to conduct the audit for the year ended on 31st March, 2006. Mr. B is holding 500 equity shares @ Rs. 50 each in W Ltd. Can SB & Co. accept audit of W Ltd.?

(4 Marks)

(c) In a medium size trading organisation the accountant was given additional responsibility of making recoveries from the debtors. On one occasion, when an insurance claim of Rs. 25,000 was received, he credited the same to the account of a debtor and misappropriated the cash which he had recovered from the said debtor. Pinpoint weaknesses in the internal control system which led to this situation. (4 Marks)

Answer

(a) (i) Removal of first auditor

As per sub- section (7) of section 224, an auditor may be removed from office before the expiry of his term, by the company in a general meeting , obtaining the prior approval of the Central Govt. in that behalf except that such approval is not required for the removal of the first auditor appointed by the directors under the proviso to sub-section (5) of section 224 of the Companies Act,1956.

Thus the first auditor appointed by the Board of Directors may be removed by shareholders merely passing an ordinary resolution, without obtaining approval of Central Govt.

In view of the above provision of law, the objection of M/s A & Co., Chartered Accountants is not correct as while removing the first auditors of the company before expiry of their term, prior approval prior approval of Central Govt. is not required.Hence the removal of the first auditors by shareholders is valid.

(ii) Buy–back of shares: Section 77A of the companies Act, 1956 provides for various conditions subject to which only the buy-back can be made. The conditions, inter-alia, provide that the buy-back is authorized by its articles. Another condition is that a special resolution is passed in general meeting of the company authorizing the buy-back.

However, such special resolution alone will not do in the absence of authority in articles.

Therefore, the Directors are wrong in their opinion. The action of the company will be illegal in view of the specific provision under section 77A of the Companies Act, 1956.

(b) Disqualification for Appointment as an auditor: Under section 226(3) of the Companies Act, 1956 a person is not qualified for appointment as auditor of a company if he/she is holding any security of that company.Securities means an instrument which carries voting rights.

A firm would also be disqualified to be appointed asa n auditor even if one partner is disqualified under this clause.

The provision relating to disqualifications aims to prohibit certain financial relationship so as to ensure that an auditor appears to be independent to the world at large.

In the given case Mr. B a partner of Chartered accountancy firm is having 500 equity shares in W Ltd. Holding 500 shares means he is having voting right., Therefore SB & Co. cannot accept audit of W Ltd. If they accept they are violating the provisions of section 226(3) (e).

(c) Following two essential features of internal control are relevant here :

(i) Breaking the chain of the work in a manner so that no single person can handle a transaction from the beginning to the end and

(ii) Segregation of accounting and custodial functions.

Weakness in internal control system in the instant case:

(a) The accountant is receiving cash and also passing the entries in the books. The accountant should not have been allowed to effect recoveries.

(b) It also appears that system for issuing receipts for amount received - whether cash or cheque- is also lacking.

(c) In a small and to some extent medium size organization, the supervision of the owner offsets the deficiencies in internal control system. But in this case, it appears, that supervision and personal control is also lacking.

Thus, in the given case, the main weakness of the system is that it is ignoring the basic requirements of a good internal control system.

Question 3

(a) Explain audit risk by reference to its components. (8 Marks)

(b) In case of government companies, Comptroller and Auditor General of India has a right to issue directions to auditor and do supplementary audit. Explain. (8 Marks)

Answer

(a) Audit Risk: Audit Risk has been discussed in AAS-6. "Audit risk" means the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated.

Components of Audit Risk : As per AAS-6 three components of audit risk are:

1. Inherent Risk - It is the susceptibility of an account balance or class of transactions to misstatement that could be material, individually or when aggregated with misstatements in other balances or classes assuming that there were no related internal controls e.g. accounts involving a high degree of management judgement or highly movable assets like jewellery will involve more inherent risk than other accounts.

2. Control Risk - It is the risk that misstatement that could occur in an account balance or class of transaction and that could be material, individually or when aggregate with misstatements in other balances or classes will not be prevented or detected and corrected on a timely basis by the accounting and internal control system. To assess control risk, the auditor should consider the adequacy of control design, as well as test adherence to control procedures. In absence of such assessment, the auditor should assume that control risk is high.

3. Detection Risk - It is the risk that an auditor's substantive procedures will not detect a misstatement that exists in an account balance or class of transactions that could be material, either individually or when aggregated with misstatements in other balances or classes. The level of detection risk relates directly to the auditor's procedures. Some detection risk would always be present even if an auditor were to examine 100 percent of the account balances.

Inherent and control risk differ from detection risk in that they exist independently of an audit of financial information. Inherent and control risk cannot be controlled by the auditor, the auditor can assess them and design his substantive procedures to produce an acceptable level of detection risk, thereby reducing risk to an acceptable low level.

(b) Power of C & AG: The audits of government companies are carried out by auditors who are appointed by C&AG. The audit is done by qualified Chartered Accountants and the audit is done on similar lines with the audits of limited companies.In addition to report under section 227, the auditors have to give report on the specific matters as contained in the directives of the C&AG.

As per section 619(3) the C&AG shall have power

a. To direct the manner in which the company's accounts shall be audited by the statutory auditor and give instruction in regard to any matter relating to the performance of his functions as such. The direction under section 619(3)(a) broadly covers the system of book keeping and accounts, internal control etc.

b. To conduct a supplementary audit or test audit by such person as he may authorize in this behalf and require the information or additional information to be provided to any person or persons so authorized, on such matters by such person or persons and in such form as C & AG may by general or special order, direct .

Thus, in case of Govt. Companies, audit is conducted by professional auditors, appointed on the advice of C & AG and the latter is authorized u/s 619(4) of the Companies Act, 1956 to conduct supplementary audit or test audit.The C&AG shall direct the manner in which the company's accounts shall be audited by the statuary auditors and give such auditors necessary instructions in regard to any matter relating to the performance of their functions as such.

The statuary auditor shall submit a copy of their audit report to C & AG who shall have right to comment upon or supplement the audit report submitted by the statuary auditors in such a manner as he may think fit.

Question 4

How will you verify/vouch the following?

(a) Loss of stock by theft. (4 Marks)

(b) Stock lying with subcontractor for fabrication. (4 Marks)

(c) Sale of empties. (4 Marks)

(d) Expenditure for advertisement in newspaper. (4 Marks)

Answer

(a) Loss of Stock by Theft

(i) The most important evidence for verification will be the First Information Report (FIR) filed with the Police for this theft.

(ii) The contents of the FIR will be cross checked with the financial books and stock records.

(iii) If no FIR is lodged, then deeper analysis will be required including satisfaction of the reasons for not filing FIR.

(iv) The quantity and value of the stolen stock is not included in the closing stock will be ensured.

(v) Verify whether such stock was insured and whether theft claim was lodged with the insurance company.

(b) Stock lying with sub-contractors for fabrication

(i) The stock lying with the sub contractor for processing should be confirmed by the confirmation letter obtained from the sub contractors.

(ii) The necessity of holding stock by them should be vouched. If the stock is lying with them for long, the reason for the same should be ascertained. The condition of the stock should be confirmed by the management.

(iii) The stock should be valued at cost or net realizable value whichever is less. The processing charges incurred should be added to the cost. The provision for the liability towards unpaid processing charges should be created.

(iv) The stock should be disclosed under the head current assets under the sub head inventory.

(v) Adjustment in accounts should be made for any discrepancies between stock confirmed and stock sent out as per memorandum records.

(c) Sale of Empties : When the empties or containers in which goods necessarily have to be supplied are costly, the manufacturer normally agrees to purchase them back at a reduced price as compared to the one charged for them. Therefore check whether

(i) Separate account of issue and receipt of empties has been prepared.

(ii) In separate maintained a/c check how many empties lies in warehouse and how many are with customers.

(iii) Check how many empties customers may return after the close of the year.

(iv) Check whether proper provision has been made against the contingency of the containers being returned by customers and that for the wear and tear.

(v) Check the amount of sale with entry in cash book.

(vi) See the sold empties are reduced from the stock.

(vii) If the empties are sold on credit, ask for direct confirmation from purchasing party and confirm the sale.

(d) Expenditure for Advertisement in News paper

(i) Vouch the copy of the newspaper sent by the newspaper/ advertisement agency to ensure that advertisement actually appeared in the newspaper.

(ii) See the date of advertisement which appeared in the newspaper should fall in the current accounting year.

(iii) Contents of advertisement should be verified to ascertain that the advertisement was of the entity and was for the business and not of personal nature.

(iv) Ensure the rate charged with the offer received for rates from newspaper and ensure that the size and placement i.e. page is in accordance with the rate charged.

(v) Ensure deduction of TDS and service tax wherever applicable.

(vi) Ensure that it is printed in all issues of the newspaper for which newspaper has charged.

Question 5

(a) Give four examples of accounting estimates. (4 Marks)

(b) State any four important elements of input control in processing of data in a computerised accounting system. (4 Marks)

(c) What are the disadvantages of the use of an audit programme? (4 Marks)

(d) Mention any four financial indications which may indicate the risk that continuance as a going concern may be questionable. (4 Marks)

Answer

(a) Examples of Accounting Estimates (any four)

(i) Allowances to reduce inventory and account receivables to their estimated realizable value.

(ii) Provisions to allocate the cost of fixed assets and their estimated useful lives.

(iii) Accrued Revenue.

(iv) Provision for taxation

(v) Provision for a loss from a law suit.

(vi) Insurer's liability for outstanding claims.

(vii) Losses on construction contracts in progress.

(viii) Amortisation of certain items like goodwill and deferred revenue expenditure.

(ix) Provision to meet warranty claims.

(x) Provision for retirement benefits like gratuity etc.

(b) Control over input in a computerized data system (any four)

(i) The input fed into the computer should be authorized. The authorization levels should be checked. The authorization is effected by levels of access to the entry for the computer system. The access control is operated through use of password and logging procedures.

(ii) The system should devise controls to check that data input are accurate.

(iii) The input document should be reviewed and verified by another person after preparation.

(iv) Transaction should be accurately converted into machine readable language and recorded in a computer data file.

(v) The transactions are not lost, duplicated, or changed without authorization.

(vi) There should be validity and cross reference checks inbuilt in the system to throw light on errors which appear in the process of feeding input.

(vii) Incorrect transactions are thrown out by a list which must be corrected, resubmitted before the process could run on the inputs.

(viii) The check digit total of financial information contained in the document or hash total may be used to act as a control tool.

(ix) The serial control may be used in inputting data that are to follow serial sequence. Any deviation in serial sequence will have to be automatically signaled out.

(c) Disadvantages of the use of an Audit Programme

(i) The work may become mechanical and particular parts of the programme may be carried out without any understanding of the object of such parts in the whole audit scheme.

(ii) The programme often tends to become rigid and inflexible following set grooves; the business may change in its operation of conduct, but the old programme may still be carried on.

(iii) Inefficient assistants may take shelter behind the programme i.e. defend deficiencies in their work on the ground that no instruction in the matter is contained therein.

(iv) A hard and fast programme may kill the initiative and innovation of efficient and enterprising assistants.

(d) Financial Indications which may indicate the risk that continuance as a going concern may be questionable (any four):

Indications of risk that continuance as a going concern may be questionable could come from the financial statements or from other sources. Financial indications which may indicate the risk that continuance as a going concern may be questionable are as under:

(i) Negative net worth or negative working capital .

(ii) Fixed term borrowings approaching maturity without realistic prospects of renewal or repayment or excessive reliance on short-term borrowings to finance long-term assets.

(iiii) Adverse key financial ratios.

(iv) Substantial operating losses.

(v) Substantial negative cash flows from operations.

(vi) Arrears or discontinuance of dividends.

(vii) Inability to pay creditors on due dates.

(viii) Difficulty in complying with the terms of loan agreements.

(ix) Change from credit to cash-on-delivery transactions with suppliers.

(x) Inability to obtain financing for essential new product development or other essential investments.

(xi) Entering into a scheme of arrangement with creditors for reduction of liability.

Question 6

Define a comprehensive Audit Progamme for auditing the receipt of fees from the students of a school run by a Charitable Trust. (16 Marks)

Answer

Audit Programme for Auditing Receipts of Fees in a School run by Charitable Trust

1. Check names entered in the Students Fee Register for each month or terms with the respective Attendance Register of the class and ensure that fees is collected from all students attending the classes.
2. Verify that there operates a system of internal check which ensures that demands against the students are properly raised.
3. Check fees received by comparing counterfoils of receipts granted with entries in the Cash Book and tracing the collection in the Fee Register to confirm that revenue from this source has been duly accounted for.
4. Total up the various columns of the Fees Register for each month or term to ascertain that fees paid in advance or in arrears is accounted for accordingly.
5. Check admission fees with admission slips signed by the head of the instruction and confirm that admission fees is credited to capital Fund.
6. Verify free studentships and concessions and ensure that a proper system and authorization exists for such cases.
7. Confirm that fines for late payment or absence etc. have been either collected or remitted under proper authority.
8. Audit the old and heavy arrears of fees and ensure such fees are not collected by staff without accounting the receipt.
9. Ensure that caution money is shown as liability.
10. Verify the cases of refund of fees.
11. Verify the cases of very old caution money refunds.
12. If fees are increased during the year ensure such increase is properly collected and accounted for.
13. Compare broadly the trend of fees receipts of last three years with reference to number of students of respective years.
14. Scrutinise Bank Reconciliation Statement to find out cheques received for fees are not dishonoured.
15. See that the investment representing endowment funds for prizes are kept separate and any income in excess of the prizes has been accumulated and invested alongwith the corpus.
16. Verify any Government or local authority grant with the memo of grant.

Question 7

(a) (i) What is a qualified audit report? (3 Marks)

(ii) Under what circumstances a qualified audit report is issued? (5 Marks)

(b) On what companies the Companies (Auditor's Report) Order, 2003 is applicable and what companies are not covered by it? (8 Marks)

Answer

(a) (i) Qualified Audit Report: Qualified reports is issued by an auditor when the auditor is not satisfied as to the truth and fairness of the accounts in certain respects which are reserved and so indicated in his report. Such reservations or exceptions are called qualifications. The auditors reports that the accounts do exhibit true and fair view of the affairs and financial status subject to or except the matters of reservations. Such type of reporting is called qualified report. In majority of cases, items which are the subject matter of qualification, are not so material as to affect the truth and fairness of the whole of the accounts but merely create uncertainty about a particular item.

According to 'Statement on Qualifications in Auditor's Report' issued by the ICAI, all qualifications should be contained in the auditor's report. The words 'subject to' are essential to state any qualification on the financial statements in clear and unambiguous manner.The auditors should state all qualifications independently in their report in an adequate manner so that a reader can assess the significance of these qualifications.

(ii) Qualified audit report is issued when-

1. The auditor is not satisfied in material respects about the truth and fairness of the accounts, proper disclosure, compliance with the Companies Act in areas concerning with financial data.
2. His non-satisfaction is due to circumstances such as limitation on scope of his work, disagreement with management or uncertainty over financial information .
3. The effect of limitation, disagreement, or uncertainty is not so material as to warrant issue of an adverse opinion so as to render the accounts as wholly untrue or unfair or a disclaimer wherein no opinion could be framed.
4. Examples are - (a) non-provision of depreciation, (b) non-provision of doubtful debts (c) disagreement as to timing of accrual of certain income (d) uncertainty as to income recognition but which had been accounted (e) the uncertainty as to recoverability of carried down values of certain assets etc.

(b) Companies covered by the CARO, 2003 : The Order applies to all companies except certain categories of companies specifically exempted from the application of the Order.The Order also applies to foreign companies as defined in section 591 of the Act. According to sub-section (1) of the aforesaid section, companies falling under the following two classes are construed as foreign companies:

(a) companies incorporated outside India which, after the commencement of the Act, establish a place of business within India; and

(b) companies incorporated outside India which have, before the commencement of the Act, established a place of business within India and continue to have an established place of business within India at the commencement of the Act.

In respect of foreign companies, an established place of business in India would include a liaison office. The Order is also applicable to the audits of branch(es) of a company under the Act since sub section 3(a) of Section 228 of the Act clearly specifies that a branch auditor has the same duties in respect of audit as the company's auditor.

Companies Not covered by the order : CARO does not apply to following companies:

(i) A banking company as defined in Clause (c) of section 5 of Banking Regulation Act, 1949;

(ii) An insurance company as defined in clause (21) of Section 2 of the Companies Act, 1956;

(iii) A company licensed to operate under section 25 of the Companies Act, 1956 and

(iv) A private limited company with a paid-up capital and reserves not more than Rs. 50 lakh and which does not have outstanding loan exceeding rupees 25 lakhs from any bank or financial institution and does not have a turnover exceeding rupees 5 crores at any point of time during the financial year.

A private limited company must satisfy all the above condition cumulatively otherwise company auditor has to report on the matters specified in CARO 2003.

Question 8

Write short notes on the following:

(a) Fundamental Accounting Assumptions (4 Marks)

(b) Provisions versus Specific Reserves (4 Marks)

(c) Sufficient Appropriate Audit Evidence (4 Marks)

(d) Auditor's Independence (4 Marks)

Answer

(a) Fundamental Accounting Assumptions : AS-1 states that certain fundamental accounting assumptions underlie the preparation and presentation of financial statements. They are usually not specifically stated because their acceptance and use are assumed. Disclosure is necessary if they are not followed. The following have been generally accepted as fundamental accounting assumptions:

(i) Going Concern: The enterprise is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of the operations.

(ii) Consistency: It is assumed that accounting policies are consistent from one period to another.

(iii) Accrual: Revenues and costs are accrued, that is, recognised as they are earned or incurred (and not as money is received or paid) and recorded in the financial statements of the periods to which they relate.

(b) Provisions versus specific Reserves : Provisions are amounts charged against revenue to provide for depreciation, renewal or diminution in the value of assets or a known liability the amount of which cannot be determined with substantial accuracy or a claim which is disputed.

Amounts contributed or transferred from profits to make good the diminution in assets values due to the fact that some of them have been lost or destroyed, as a result of some natural calamity or debts have proved to be irrecoverable are also described as provisions. Provisions are normally charged to the Profit and Loss Account before arriving at the amount of profit.

On the other hand, a specific reserve is created for some definite purpose out of the profits of the company. The purpose may be anything connected with the business which the Article of Association, or the directors want to be provided for, such as dividend equalization, replacement of fixed assets, expansion of the organization, Income-tax liability for future foreign exchange fluctuation etc. Though the concerned amounts are carried under the earmarked heads, these are available for distribution as dividend on the recommendation of directors but subject to the approval of shareholders, since these are created by appropriation of profits. To create any specific reserve, existence of profit is essential. Some of the specific reserves may be required under the contractual obligations or legal compulsion, for example: (i) funds for redemption of debentures and (ii) development rebate reserve.

Thus provisions are amounts set apart to meet specific liabilities. These must be provided for regardless of the fact whether or not any profit has been earned by the concern. While to create any specific reserve, existence of profit is essential.

(c) Sufficient Appropriate Audit Evidence : AAS 1 on basic principles governing an audit states “the auditor should obtain sufficient appropriate audit evidence through the performance of compliance and substantive procedure, to enable him to draw a reasonable conclusion therefrom on which to base his opinion on the financial information”.Sufficiency and appropriateness are interrelated and apply to evidence obtained from both compliance and substantive procedures. Sufficiency refers to the quantum of audit evidence obtained; appropriateness relates to its relevance and reliability. The auditor should evaluate whether he has obtained sufficient appropriate audit evidence before he draws his conclusions therefrom. The evidence should, in total, enable the auditor to form an opinion on the financial information.

(d) Auditor's Independence : Independence is the keystone upon which the respect and dignity of a profession is based. Independence implies that the judgement of a person is not subordinate to the wishes or directions of another person who might have engaged him or to his own self interest. The independence is a condition of mind and personal character and should not be confused with the superficial and visible standards of independence which are sometime imposed by law. In the context of auditors, his independence is necessary so as to enable him to express unbiased opinion on financial statements. The user of the financial statement will rely on the opinion of the auditor only when he is convinced about his independence. Independence of the auditor has not only to exist in fact, but should also appear to so exist to all reasonable persons.

The chartered accountant is not known personally to the third parties who rely on professional opinion and accept his opinion and accept his opinion principally on a larger faith on the entire accounting profession.

The Companies Act, 1956, has therefore enacted specific provisions to give concrete shape to this vital concept:

(i) The provisions disqualifying certain types of persons from undertaking audit of limited companies.

(ii) Provisions relating to ceiling on the number of audits that can be undertaken by a chartered accountant.

(iii) Provisions requiring special resolution for appointing auditors in certain cases.

(iv) Other provisions on appointment, re-appointment and removal of auditors, are designed with sufficient independence to carry out the audit in the larger interest of shareholders and other users.

(v) Power to qualify his report is yet another weapon in the armory of the auditor to protect his independence.

PAPER – 3 : BUSINESS AND CORPORATE LAWS

Question Nos. 1 & 7 are compulsory. Candidates are required to attempt four questions out of questions 2, 3, 4, 5 and 6 and two questions out of questions 8, 9 and 10.

Question 1

Answer any four of the following:

(a) Y holds agricultural land in Gujarat on a lease granted by X, the owner. The land revenue payable by X to the Government being in arrear, his land is advertised for sale by the Government. Under the Revenue law, the consequence of such sale will be termination of Y's lease. Y, in order to prevent the sale and the consequent termination of his own lease, pays the Government, the sum due from X. Referring to the provisions of the Indian Contract Act, 1872 decide whether X is liable to make good to Y, the amount so paid ?

(b) A, an agent of a buyer, had obtained goods from the Railway organization and loaded the goods on his truck. In the meantime, the Railway organization received a notice from B, a seller, for stopping goods in transit as the buyer had become insolvent. Referring to the provisions of the Sale of Goods Act, 1930 decide whether the Railway organization can stop the goods in transit, as instructed by the seller ?

(c) A and B entered into an agreement to carry on a business of manufacturing and selling toys. Each one of them contributed Rs. 35 lacs as their capital with a condition that A and B will share the profits equally, but the loss, if any is to be borne by A alone. Referring to the provisions of the Indian Partnership Act, 1922 decide whether three exists a partnership between A and B.

(d) A owns a certain sum of money to B. A does not know the exact amount and hence he makes out a blank cheque in favour of B, signs and delivers it to B with a request to fill up the amount due payable by him. B fills up fraudulently the amount larger than the amount due, payable by A and endorses the cheque to C in full payment of dues of B. Cheque of A is dishonoured. Referring to the provisions of the Negotiable Instruments Act, 1881, discuss the rights of B and C.

(e) Examine whether the Payment of Bonus Act, 1965 be applicable to the following cases:

  (i) J, who is working in a social welfare organization.

  (ii) D, an employee employed by an establishment engaged in an industry carried on by a department of the Central Government.

(f) While an employee may increase his contribution to Provident Fund, is an employer also liable to proportionately increase his contribution to the above under the Employees Provident Funds and Miscellaneous Provisions Act, 1952 ? Explain. (4×5 =20 Marks)

Answer

(a) Yes, X is bound to make good to Y the amount so paid. Section 69 of the Indian Contract Act, 1872, provides that "A person who is interested in the payment of money which another is bound by law to pay, and who therefore pays it, is entitled to be reimbursed by the other. In the given case Y has made the payment of lawful dues of X in which Y had an interest. Therefore, Y is entitled to get the reimbursement from X.

(b) The right of stoppage of goods in transit can be exercised only so long as the goods are in the course of transit. In the given case the transit was at an end as soon as the agent of the buyer obtained goods from the Railway Organisation. Therefore Railway Organisation cannot act as instructed by the seller, who has lost the light of stoppage of the goods in transit as provided in (Section 30 Sale of Goods Act, 1930)

(c) Yes, it is a case of partnership between A and B as sharing losses is not an essential condition to create a partnership. Section 13(b) of the Indian Partnership act 1932 provides Subject to the contract between the partners, the partners are entitled to share equally in the profits earned, and shall contribute equally to the losses sustained by the firm." In the given case the partners make a contract contrary to this provision where A agrees to bear all the losses of the business.

(d) Section 44 of the Negotiable Instruments Act 1881 is applicable in this case. According to Section 44 of this Act, B who is a party in immediate relation with the drawer of the cheque is entitled to recover from A only the exact amount due from A and not the amount entered in the cheque. However the right of C, who is a holder for value, is not adversely affected and he can claim the full amount of the cheque from B.

(e) (i) As per the provisions contained in Section 32 (v) (c) of the Payment of Bonus Act, 1965, 'J' is not entitled to any bonus as the said Act is not applicable to social welfare organization.

(ii) Similarly the said Act is not applicable to the employees engaged by a Department of the Central Government vide Section 32 (iv).

(f) Section 6 of the Employees Provident Fund and Miscellaneous Provisions Act, 1952 provides that an employee can at his will contribute beyond 10% if the scheme makes provision therefor subject to the condition that the employer shall not be under an obligation to pay any contribution over and above his contribution payable under this section.

Question 2

(a) Examine whether the following constitute a contract of 'Bailment' under the provisions of the Indian Contract Act, 1872:

(i) V parks his car at a parking lot, locks it, and keeps the keys with himself.

(ii) Seizure of goods by customs authorities. (5 Marks)

(b) State the circumstances under which the Registrar of Societies may cancel the registration of a society registered under the Cooperative Societies Act, 1912. What is the effect of such cancellation ? Explain. (5 Marks)

Answer

(a) (i) No. Mere custody of goods does not mean possession. For a bailment to exist the bailor must give possession of the bailed property and the bailee must accept it (Section 148, Indian Contract Act, 1872 is not applicable).

(ii) Yes, the possession of the goods is transferred to them custom authorities (section 148) is applicable.

(b) The Registrar may cancel the registration of a society under the Co-operative Societies Act, 1912 in the following circumstances:

(i) If the Registrar, after an inquiry has been held by him under Section 35 of the Act, into the constitution, working and financial condition of a registered society, or after a inspection of the books of a society, or after inspection of the books of a society has been made under Section 36, or on receipt of an application made by three-fourths of the members of the members of a society, is of opinion that the society ought to be dissolved. The cancellation take effect after the expiry of two months from the date of the order of cancellation, if no appeal is preferred against the order by any member within that period. If, however, an appeal is presented within that period, the cancellation takes effect only when it is confirmed by the appellate authority i.e., the State Government (Section 39)

(ii) Where it is a condition of the registration of a society that it should consist of at least ten members, and it is proved to the satisfaction of the Registrar that the number of the members has been reduced to less than ten. In this case, the cancellation takes effect from the date of the order (Section 40 and 41).

The effect of such cancellation is that the society ceases to exist as a corporate body from the date the cancellation take effect (Section 41) and the Registrar may appoint a competent person to be liquidator of the society (Section 42)

Question 3

(a) A contracted with B to supply him (B) 500 tons of iron-steel @ Rs. 5,000 per ton, to be delivered at a specified time. Thereafter, A contracts with C for the purchase of 500 tons of iron-steel @ Rs. 4,800 per ton, and at the same time told 'C' that he did so for the purpose of performing his contract entered into with B. C failed to perform his contract in due course. Consequently, A could not procure any iron-steel and B rescinded the contract. What would be the amount of damages which A could claim from C in the circumstances ? Explain with reference to the provisions of the Indian Contract, 1872.

(5 Marks)

(b) A, B and C are partners in a firm called ABC Firm. A, with the intention of deceiving D, a supplier of office stationery, busy certain stationery on behalf of the ABC Firm. The stationery is of use in the ordinary course of the firm's business. A does not give the stationery to the firm, instead brings it to his own use. The supplier D, who is unaware of the private use of stationery by A, claims the price from the firm. The firm refuses to pay for the price, on the ground that the stationery was never received by it (firm). Referring to the provisions of the Indian Partnership Act, 1932 decide:

(i) Whether the Firm's contention shall be tenable ?

(ii) What would be your answer if a part of the stationery so purchased by A was delivered to the firm by him, and the rest of the stationery was used by him for private use, about which neither the firm nor the supplier D was aware? (5 Marks)

Answer

(a) The problem in the question is based on the provisions of the Indian Contract Act, 1872 as contained in Section 73. Section 73 provides that when a contract has been broken the party who suffers by such breach is entitled to receive from the party who has broken the contract compensation for any loss or damage caused to him thereby which naturally arose in the usual course of things from such breach or which the parties knew when they made the contract to be likely to result from the breach of it. The leading case in this point is Hadley v Baxendale.

In a leading case of "Hadley vs. Baxendale" it was decided that if the special circumstances under which the contract was actually made were communicated by the plaintiffs to the defendants, and thus known to both parties, the damages resulting from the breach of such a contract which they would reasonably contemplate, would be the amount of injury which would ordinarily follow from a breach of contract under these special circumstances so known and communicated.

In the instant case 'A' had intimated to 'C' that he was procuring iron steel from him for the purpose of performing his contract whit 'B' Thus, C had the knowledge of the special circumstance. Therefore, is entitled to claim from 'C' Rs. 1,00,000 (difference between the procuring price of iron steel and contracted selling price to 'B') being the amount of profit 'A' would have made by the performance of his contract with 'B'. If A had not told C of B's contract then the amount of damages would have been the difference between the contract price and the market price on the day of default

If 'A' had not told 'c' of B's contract then the amount of damages would have been the difference between the contract price and the market price on the day of default.

(b) The problem in the question is based on the 'Implied Authority' of a partner provided in Section 19 of the Indian Partnership Act 1932. The section provides that subject to the Indian Partnership Act, 1932, the section provides that subject to the provisions of Section 22 of the Act, the act, the act of a partner, which is done to carry on, in the usual way, business of the kind carried on by the firm, binds the firm. The authority of a partner to bind the firm conferred by this section is called his 'Implied Authority' [Sub-Section (i) of section 19]. Further more, every partner is in contemplation of law the general and accredited agent of the partnership and may consequently bind all the other partners by his acts in all matters which are within the scope and object of the partnership Hence, if the partnership is of a general commercial nature, he may buy goods on account of the partnership.

Considering the above provisions and explanation, the questions as asked in the problem may be answered as under:

(i) The firm's contention is not tenable, for the reason that the partner, in the usual course of the business on behalf of the firm has on implied authority to bind the firm. The firm is, therefore, liable for the price of the goods,

(ii) In the second case also the answer would be the same as above, i.e. the implied authority of the partner binds the firm.

In both the cases, however, the firm ABC can take action against A, the partner but it has to pay the price of stationery to the supplier D,

Question 4

(a) Mr. S agreed to purchase 100 bales of cotton from T, out of his large stock and sent his men to take delivery of the goods. They could pack only 60 bales. Later on, there was an accidental fire and the entire stock was destroyed including 60 bales that were already packed. Referring to the provisions of the Sale of Goods Act, 1930 explain as to who will bear the loss and to what extent? (5 Marks)

(b) Explain the meaning of the term 'Basic Wages' under the Employees' Provident Funds and Miscellaneous Provisions Act, 1952. (5 Marks)

Answer

(a) Section 26 of the Sale of Goods Act, 1930 provides that unless otherwise agreed, the goods remain at the seller's risk until the property there in is transferred to the buyer, the goods are at buyer's risk whether delivery has been made or not. Further Section 18 read with Section 23 of the Act provide that in a contract for the sale of unascertained goods, no property in the goods is transferred to the buyer, unless and until the goods are ascertained where there is contract for the sale of unascertained or future goods by description and goods of that description and in a deliverable state are unconditionally appropriated to the contract, either by the seller with the assent of the buyer or by the buyer with the assent of the seller, the property in the goods thereupon passes to the buyer. Such assent may be express or implied. Applying the aforesaid law to the facts of the case in hand, it is clear that Mr. S has the right to select the good out of the bulk and he has sent his men for same purpose.

Hence the problem can be answered based on the following two assumptions and the answer will vary accordingly.

Where the bales have been selected with the consent of the buyer's representatives:

(i) In this case the property in the 60 bales has been transferred to the buyer and gods have been appropriated to the contract. Thus loss arising due to fire in case of 60 bales would be borne by Mr. S. As regards 40 bales, the loss would be borne by Mr. V, since the goods have not been identified and appropriated.

(ii) Where the bales have not been selected with the consent of buyer's representatives:

In this case the property in the goods has not been transferred at all and hence the loss of 100 bales would be borne by Mr. V completely.

(b) Basic wages" means all emoluments which are earned by an employee while on duty or on duty or on leave or on holidays with wages in either case in accordance with the terms of the contract of employment and which are paid or payable in cash to him, but does not include:

(i) the cash value of any food concessions;

(ii) any dearness allowance (that is to say all cash payment, by whatever name called, paid to an employee on account of rise in the cost of living), house rent allowance, overtime allowance, bonus, commission or pay and other similar allowance payable to the employee in respect of his employment or of work done in such employment; or

(iii) any presents made by the employer. (Section 2(h), EPF & MP Act, 1952.

Question 5

(a) Referring to the provisions of the Negotiable Instruments Act, 1881, examine the validity of the following:

(i) A bill of Exchange originally drawn by M for a sum of Rs. 10,000, but accepted by R only for Rs. 7,000.

(ii) A cheque marked 'Not Negotiable' is not transferable. (5 Marks)

(b) Explain the provisions of the Multi-State Cooperative Societies Act, 2002 relating to the appointment and removal of auditors of a society registered under the Act. (5 Marks)

Answer

(a) (i) As per the provisions of the Negotiable Instruments Act 1881, acceptance may be either genial or qualified. It is qualified when the drawee does not accept the bill according to the apparent tenor of the bill but all aches same condition or qualification which have the effect of either reducing his (acceptor's) liability or acceptance of this liability is subject to certain condition, the holder of the bill is entitled to require an absolute and unconditional acceptance, otherwise he will treat it as dishonoured however, he may agree to qualified acceptance nut he does so at his own peril, since he discharge all parties prior to himself, unless he has obtained their consent.

Thus in this given case in accordance with the Explanation to Section 86 of the Act, when the drawee undertakes the payment of part only of the same ordered to be paid. it is a qualified acceptance and the drawer may treat it as dishonoured to unless agreed by him. If the Drawer (M) agrees to acceptance, the drawee (R) is responsible for a sum of Rs. 7000 only.

(ii) It is wrong statement. A cheque marked "not negotiable" is a transferable instrument. The inclusion of the words 'not negotiable' however makes a significant difference in the transferability of the cheques. The holder of such a cheque cannot acquire title better than that of the transferor.

(b) Provision relating to appointment and removal of auditors: (Section 71, Multi-State Co-operative Societies Act, 2002)

(1) A 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.

(2) On receipt of notice of such a resolution, the multi-state co-operative society shall forth with send a copy there of to the retiring auditor.

(3) Where such notice is given and the retiring auditor makes representations in writing to the society (not exceeding a reasonable length) and requests their notification to members, the society shall, (unless the representation are received by it too late):

(a) state the fact of the representations having been made, in any notice of the resolution given to members, and

(b) send a copy of the representation to every member of the multi-state co-operative society to whom notice of the meeting is sent.

(4) If a copy of the representation is not sent to the members because they were received too late or because of the society's default, the auditor may (without prejudice to his right to be heard orally) require that the representation shall be read out at the meeting.

Question 6

(a) During the accounting year 2005-06, XYZ Limited to which the Payment of Bonus Act, 1965 applies, suffered heavy losses. The Board of Directors of the company decided not to pay any body us to its employees. The employees moved the Court for relief. Referring to the provisions of the Act, decide whether the employees of the company would be given any relief by the Court? (5 Marks)

(b) State the grounds on which a member of a society registered under the Multi-State cooperative Societies Act, 2002 may be expelled from the membership of the Society. (5 Marks)

Answer

(a) Yes, They will succeed. Even if the employer suffers losses during the accounting year he is bound to pay minimum bonus as prescribed by section 10 of the payment of Bonus Act, 1965. i.e.8.33% of the basic wages (State Vs Sardar Dalip Singh Majilhia, 1979)

(b) The bye-laws of a co-operative society registered under the Multi State Co-operative Society Act, 2002 may provide that a member may be expelled if:

1. he fails to fulfil his obligations in the matter of dues (the number of months' arrears being specified).
2. he becomes a member of another similar society and refuses to withdraw (because according to the policy of publicity, each member has the right to inspect the books of the society and may pass information to a rival society of which he is a member).
3. he is to be proceeded against for debts.
4. he becomes insolvent.
5. he engages in such activities as might be contrary to the principles of the society.
6. he becomes insane.
7. he is convicted by as criminal court, especially of bribery, forgery, theft or fraud; and
8. he has committed an act, which is considered dishonourable by the Managing Committee.

Further, if a member of a society with unlimited liability joins another society and so pledges his liability join another society and so pledges his liability twice over, he should be expelled.

Question 7

Answer any four of the following:

(a) The object clause of the Memorandum of Association of LSR Private Ltd, Lucknow authorized to do trading in fruits and vegetables. The company, however, entered into a Partnership with Mr. J and traded in steel and incurred liabilities to Mr. J. The Company, subsequently, refused to admit the liability to J on the ground that the deal was 'Ultra Vires' the company. Examine the validity of the company's refusal to admit the liability to J. Give reasons in support of your answer. (5 Marks)

(b) VRS Company Ltd. Is holding 45% of total equity shares in SV Company Ltd. The Board of Directors of SV Company Ltd. (incorporated on January 1, 2004) decided to raise the share capital by issuing further Equity shares. The Board of Directors resolved not to offer any shares to VRS Company Ltd, on the ground that it was already holding a high percentage of the total number of shares already issued, in SV Company Ltd. The Articles of Association of SV Company Ltd. provide that the new shares be offered to the existing shareholders of the company. On March 1, 2007 new shares were offered to all the shareholders except VRC Company Ltd. Referring to the provisions of the Companies Act, 1956 examine the validity of the decision of the Board of Directors of SV Company Limited of not offering any further shares to VRS Company Limited. (5 Marks)

(c) X, a registered shareholder of Y limited left his share certificates with his broker. A forged the transfer deed in favour of Z, accompanied by these share certificates lodged the transfer deed alongwith the share certificates with the company for registration. The Company Secretary who had certain doubts, wrote to X informing him of the proposed transfer and in the abse of a reply from him (X) within the stipulated time, registered the transfer of shares in the name of Z. Subsequently, Z sold the shares to J and J's name was placed in the register of shareholders. Later on, X discovered that forgery has taken place.

Referring to the provisions of the Companies Act, 1956, state the remedy available to X and Z in the given case. Explain. (5 Marks)

(d) The paid-up Share Capital of AVS Private Limited is Rs. 1 crore, consisting of 8 lacs Equity Shares of Rs. 10 each, fully paid-up and 2 lacs Cumulative Preference Shares of Rs. 10 each, fully paid-up. XYZ Private Limited and BCL Private Limited are holding 3 lacs Equity Shares and 1,50,000 Equity Shares respectively in AVS Private Limited.

XYZ Private Limited and BCL Private Limited are the subsidiaries of TSR Private Limited.

With reference to the provisions of the Companies Act, 1956, examines whether AVS Private Limited is a subsidiary of TSR Private Limited ? Would your answer be different if TSR Private Limited has 8 out of total 10 directors on the Board of Directors of AVS Private Limited ? (5 Marks)

(e) State the purposes for which the object clause of the Memorandum of Association of a public limited company, registered under the Companies Act, 1956, can be altered. (5 Marks)

Answer

(a) In terms of Companies Act, 1956, the powers of the company are limited to:

(i) Powers expressly given by the Memorandum (which is popularly known as 'express' power or conferred by the companies Act 1956, or other statue and (ii)

(ii) powers reasonably incidental or necessary to the company's main purpose (termed as "Implied' powers). The Act further provides that the acts beyond the powers of a company are ultra virus and void and cannot be ratified even though every member of the company may give his concert [Ashbury Railway Carriage Company Vs Richee]

The object clause enable shareholders, creditors or others to know what its powers are and what is the range of its activities and enterprises, the objects clause in therefore is of fundamental importance to the share holder, creditors and other.

M/s LSR Pvt. Ltd is authorised to trade directly on fruits and vegetables. It has no power to enter into a partnership for Iron and steel with Mr. J, Such act can never be treated as 'express' or 'implied' powers to the company. Mr J who entered into partnership is deemed to be aware of the lack of powers of M/s LSR (Pvt) Ltd. In the light of the above, Mr, J cannot enforce the agreement or liability against M/s LSR Pvt. Ltd Rr. J should be advised accordingly. This conclusion is supported by the decision reported in the case of 'The Ganga Mata Refinery Company (Pvt) Ltd CIT.

(b) The problem as asked in the question is based on the application of the precisions of the Companies Act, 1956 as contained in Section 81 and the ruling given in Gas Meter Co. Ltd. Vs Diaphragm & General leather co. Ltd.

According to Sec 81 if, at any time after the expiry of two years from the formation of the company of after the expiry of One year from the first allotment of shares, whichever is earlier, it is proposed to raise subscribed capital by allotment of further shares, it should be offered to the existing equity share holder of the company in proportion to the capital paid upon those shares. Further in case of Gas Meter Ltd. Vs Diaphragm, & General; leather Co. Ltd where the facts of the case were similar to those given in the problems asked in the question, the articles of Diaphagm Co. provided that the new shares should first be offered to the exciting share holders. The company offered new shares to all shareholders excepting Gas Co., which held its controlling shares. It was held that D company could be sustained from doing this.

In the given case applying the provisions and the ruling in the above case, SV Ltd.'s decision not to offer any further shares to VRS Co. ltd on the ground that VRS Co. Ltd already hold a high percentage of shareholding in SV Co. Ltd. is not valid for the reason that it is violative of the provisions of Section 81 and against the ruling in the above case.

Secondly, the offer for issue of the shares was made on 1st March 2007, i.e. after two years of the formation of the company. Therefore Board of Directors of SV Ltd cannot take a decision not to allot shares to VRS Company, unless the same is approved by the Co. in general meeting by means of special resolution as required under Section 81 (A).

(c) In the given case, there is a forged transfer of shares. The company in such a case should first inquire into the validity of the instrument of transfer. It should also send a notice to the transfer or of his address and inform him that such a transfer has been lodged and if no objection is made before this specified date, it would be registered.

Remedies available to X:

Since a forged transfer is nullity, it does not pass any legal title to the transferee. The true owner can have his name restored on the register of member. A forged document can never have any legal effect.

(1) Can also claim any dividend, which may not have been paid to him during the intervention period. (Barton V North Staffordshire)

Remedy to Z:

(2) If by forgery a person obtain a certificate of transfer of shares from a company and transfers the shares to a purchaser for value acting in good faith i.e. without the knowledge of forgery, such purchaser does not get good title to the shares so transferred because a forged transfer is a nullity and cannot be a source of a valid transfer of title. But the company shall be liable to compensate the purchaser in so far as the company had issued a certificate to transfer and was therefore, estopped from denying the liability accruing from his own ach therefore, if Z has suffered any loss, he can claim it from the company in this case.

(d) Holding, subsidiary relationship: For the purpose of determining whether a company is subsidiary of another company, only equity shares issued by the first mentioned company are to be taken into account [Section 4 (1) (b) (ii), Companies Act, 1956].

Again, share held by a subsidiary company shall be treated as held by its holding company [Section 4 (3) (b) (ii)] If a company by itself or along with its subsidiaries holds more than half in nominal value of the equity shares capital of another company, it will be considered as the holding company of the other company [Section 4(3) (b) (ii)]

In this case, the equity share capital of AVS Pvt. Ltd. is Rs. 80,00,000 consisting of 8,00,000 equity shares of Rs 10 each fully paid up XYZ and BCL Pvt. Ltd. are holding 4,50,000 (3,00,000+1,50,000) equity shares in AVS Pvt Ltd., tsr Prt, Ltd will be treated as holding more than half in nominal value of the equity share capital of AVS Pvt Ltd.

If TSR Pvt. Ltd. controls the composition of the board of Directors of AVS Pvt. Ltd; it will also be treated as holding company by virtue of Section 4 (1) (a). Hence the answer will not be different.

(e) The members of a company may rightly expect that their money would be employed only for the objects for which the company has been established. Accordingly, the Act permits alternation of the object, only so far as is considered necessary for specified purposes. Section 17 (1) permits a company to alter its objects for the under mentioned purposes:

(a) to carry on business mire economically:

(b) to attain the main purpose of the company by new or improved means:

(c) To carry on some business which under the existing circumstance may conveniently or advantageously be combined with the existing business.

(d) To change and enlarge the local area of operations;

(e) To restrict or abandon any of the existing objects;

(f) To sell or dispose of the whole or any part of the undertaking;

(g) To amalgamate with any other objects or body or person.

Question 8

(a) Explain the provisions of the Companies Act, 1956 relating to the ‘Service of Documents’ on a company and the members of the company. When is service of document deemed to be effective in case the document is sent by post ?Explain. (5 Marks)

(b) State any six charges which are required to be registered under the provisions of the Companies Act, 1956. What is the effect of non-registration of a charge required to be registered under the Act ? Explain. (5 Marks)

Answer

(a) Accordingly to Section 53 of the Companies Act, 1956, a company may serve a document on its member either personally or by sending it by post to him, to his registered address, or if he residing abroad in India (who may be residing abroad) to the address (if any) with in India supplied by him to the company for giving notices to him [Section 53 (1)] if a person residing abroad has not supplied to the company on address within in India for the purpose of giving notice to him, then a document advertised in a newspaper circulating in the neighborhood of the registered office of the company shall be deemed to be duly served on him on the day on which the advertisement appears. [Section 53 (3)] In the case of joint holders of a share, notice may be served on the joint holder name first [Section 53(4)] When a share holder dies, it becomes the duty of the legal representative to furnish their address for a notice to be sent and if they fail to send the intimation to the company, the company is entitled to serve at the address which is recorded with it. The same rule applies in the case of insolvent member, when the assignees have not furnished their address [Section 53 (5)].

Where a document is sent by post, it is enough if the letter containing the document is properly addressed and sent by ordinary post. But at the request of a any member, notice may be served by registered post or under certificate of posting, provided the member has deposited adequate money to meet the express {Section 53 (2) (a)].

Where a document is served by post, service shall be deemed to have been effected:

(1) In the case of notice of a meeting at the expiration of 48 hours after the letter containing the same is posted, and

(2) In any other case at the time at which the letter would be delivered on the ordinary course of post.

(b) The following are the charges required to be registered with the registrar of companies within 30 days after the date of its creation: As per Section 125, Companies Act, 1956

(i) a charge for the purpose of securing any issue of debentures;

(ii) a charge on uncalled share capital of the companies.

(iii) a charge on any immovable property, wherever, situated, or any interest therein,

(iv) a charge on any book debt of the company.

(v) a charge not being a pledge, on any movable property of the company;

(vi) a floating charge on the undertaking or any property of the company including stock-in-trade;

(vii) a charge on calls made but not paid,

(viii) a charge on a ship or any share in ship;

(ix) a charge on goodwill on a patent or licence under a patent, on a trademark or on a copyright or a license under a copy right.

Effect of non registration of charge: -

If any of the charges is not registered, it shall be void against the liquidators and any creditor of the company [Section 125 (1)] (Monalithic Building Co.)

When the charge becomes void, the money secured thereby shall immediately become payable (Section 125 (3). The company and every officer of the company may be subjected to a penalty up to Rs. 5000 for every day during which the default continues. In the event of the charge being void for non registration no right of lien can be claimed on the documents of title, as they are only ancillary to the charged and were delivered pursuant to the charge (In re Mottar Ltd,) Though the charge becomes void for non-registration, but the debt is good as a simple debt is good as a simple debt (e. Padam ji Co. V Moose)

Question 9

(a) Though six out of seven signatures to the Memorandum of Association of a company were forged, the company was registered and the Certificate of Incorporation issued. Can the registration of the company be challenged subsequently on the ground of forged signatures ? (5 Marks)

(b) Who are the persons entitled to receive notice of a general meeting of a company, registered under the Companies Act, 1956 ? Shall the non-receipt of notice of the general meeting by any member invalidate the proceedings of the meeting ? Explain. (5 Marks)

Answer

(a) No. Registration cannot be challenged. Section 35 of the Companies Act 1956 declares that certificate of incorporation given by the Registrar in respect of any company shall be conclusive evidence that all the requirements of the Act have been complied with in respect of registration and matters precedent and incidental thereto, and that the association is company authorized to be registered and duly registered under the Act. (Peel's Case)

(b) Persons entitled to notice: Notice of the meeting shall be given:

  (a) To every member of the company;

  (b) To the persons entitled to a share in consequence of the death or insolvency of a member;

  (c) To a auditor or auditors [Section 172 (a); and

  The company cannot take notice of the beneficial owner of shares who are, therefore, not entitled to receive notice. Where, however, anyone is legally entitled to represent the member, such representative is entitled to receive the notice.

  A private company, which is not, a subsidiary or a public company may prescribe, by its Articles, persons to whom the notice should be given. It does not always follow that all the members of a company are entitled to receive notice of meetings of the company; the Articles frequently provide that preference shareholders shall not be entitled to receive notice of and vote at general meeting of the company, except in certain circumstances. There is a statutory obligation to send notice to preference shareholders when their dividend is in arrears for more that a certain period [section 87(2) (b)]. This obligation arises from the fact that preference shareholders whose dividends are in arrears are entitled to attend and vote at the meeting.

  The non-receipt of notice or accidental omission to given notice to any member shall not invalidate the proceeding in the meeting [Section 172 (3)]. However, omission to serve notice of meeting on a member on the mistaken ground that he is not shareholder cannot be said to be an accidental omission [Musselwhite Vs. C.H. Musselwhite & sons Ltd. (1962) 32 Comp. Cas 804] 'Accidental omission' means that the omission must be not only designed but also not deliberate [Maharaja Export Vs. Apparels Exports Promotion Council (1986) 60 Comp. Cas 353.].

Question 10

(a) ABC Limited served a notice of a general meeting upon its members. The notice stated that a resolution to increase the Share Capital of the company would be considered at the meeting. A member complains to the company that the amount of the proposed increase was not specified in the notice. In the light of the provisions of the Companies Act, 1956, examine the validity of the notice. (5 Marks)

(b) XYZ Limited held its Annual General Meeting on September 15, 2006. The meeting was presided over by Mr. V, the Chairman of the Company's Board of Directors. On September 17, 2006, Mr. V, the Chairman, without signing the minutes of the meeting, left India to look after his father who fell sick in London. Referring to the provisions of the Companies Act, 1956, state the manner in which the minutes of the above meeting are to be signed in the absence of Mr. V and by whom. (5 Marks)

Answer

(a) Section 173 of the Companies Act, 1956 requires a company to annex an explanatory statement to every notice for a meeting of company, at which some 'special business' is to be transacted. This explanatory statement is to bring to the notice of members all material facts relating to each item of special business. Section 173 further specifies that all business in case of any meeting is regarded as special business. Thus, the objection of the shareholder is valid since the details on the item to be considered are lacking. The information about the amount is a material fact with reference to the proposed increase of share capital. The notice is, therefore, not a valid notice under Section 173.

(b) By virtue of Section 193 (1A) (b) of the Companies Act, 1956, minutes of proceeding of general meeting can be signed and dated within a period of 30 days, by a director duly authorized by the board for the purpose. In the circumstances contemplated by the question, therefore, a Board meeting has to be convened and one of the directors present there at be authorized to sign and date the minutes of the annual general meeting.

SUMMARY OF EXAMINERS' COMMENTS ON THE PERFORMANCE OF CANDIDATES

PAPER – 1 : ACCOUNTING

General Comments

The performance of the candidates has not been satisfactory. The answers of the candidates showed lack of knowledge and understanding of the subject, specially the accounting standards. It is also observed that the candidates neglect the theoretical aspects of the subject, they are advised to go through the study material carefully. The solutions to practical problems must be given in suitable formats along with sufficient working notes. It is suggested that the question paper should be gone through carefully before writing the answers. A thorough practice and lots of reading of the subject is required to maintain the level of knowledge expected from the students of PE II Level.

Specific Comments

Question 1. Partnership Accounts: The performance of the candidates was not up to the mark. Most of them failed to ascertain the amount of cash brought in by partners, A and B. Few among them could not show the correct treatment for the asset gifted by A and B to C and consequently, they were not able to prepare realization account, cash account and partners' capital accounts.

Question 2. Internal Reconstruction of a Company: The performance of the candidates was not satisfactory in this part of the question. Many candidates could not give the required journal entry for the settlement of tax liability. Few candidates could not derive the correct amount of balancing figure (transferred to capital reserve) of capital reduction account.

Question 3. Branch Accounts: Most of the candidates performed fairly well in this question. However, some of them could not prepare the branch stock and branch adjustment account properly , as a result of which the correct profit could not be ascertained.

Question 4. (a) Computation of Provision required in the Profit and Loss Account of a Bank: This question was satisfactorily answered by most of the candidates. Most of them did not apply the correct percentages of provisioning, and therefore they were not able to compute the correct amount of provision required in the Profit and Loss Account of Bank.

(b) Accounts of Electricity Supply Company: The candidates have performed badly in this question. Most of the candidates could not prepare the statement showing value of the asset to be capitalized and the amount to be written off to revenue account. They were not able to draw the required journal entries.

Question 5.Insolvency Accounts of Non-Corporate Entities: The overall performance was poor in this question. Except few, all of the candidates failed to attempt the question correctly. Many candidates did not calculate the correct amounts of List A creditors and properties according to List E. Some of them failed to compute the accumulated profit correctly and therefore, could not prepare the deficiency account correctly.

Question 6. Theory Question

(a) AS 7: The performance of the candidates in this part of the question was unsatisfactory. Only few candidates could give the disclosure requirements of AS 7 in the required manner.

(b) Accounting for Govt. Grants: This question was satisfactorily answered by majority of the candidates. However, some candidates could not write about the depreciation provision.

(c) Actuarial Valuation: The overall performance was poor in this part of question. Some of the candidates confused actuarial valuation with accrual basis of accounting and wrote irrelevant answer.

(d) Uses of Accounting Information in Agriculture Farm: Average performance was observed in this part of the question. Some of the candidates described the problems of the farmers rather than the information that can be extracted from the well designed accounting system.

(e) B list Contributories: This question was satisfactorily answered by majority of the candidates.

(f) AS 10: Most of the candidates performed fairly well in this part of the question.

PAPER – 2 : AUDITING

General Comments

1. Answers of the candidates showed lack of knowledge and understanding of the subject especially accounting standards, AAS and Companies Act.
2. Instructions given for writing answers were not followed strictly by most of the candidates.
3. In many cases, answers to sub-questions were not in proper sequences and were scattered throughout the paper.
4. Handwriting of many candidates appeared illegible.
5. Language used for writing answers in general was poor.
6. It was observed that candidates have written unnecessary and irrelevant texts to enlarge the length of answers or just to show off the questions have been attempted.

Specific Comments

Question 1. (a) The answers were not at all satisfactory. Only a few could correlate the answer with AAS-19. Some of the candidates found fault with the branch auditor who qualified the report on non-provision of a major debt.

(b) Most of the candidates mentioned that interest should be capitalized and added with cost of investments. Many candidates were not aware of the provisions of AS-16 on borrowing cost. Only few candidates mentioned that the investment of Rs. 10 crores in shares of B Ltd by A Ltd cannot be considered as qualifying asset and hence interest of Rs. 1 crore should not be capitalized and should be shown as expenditure in the profit & loss account. Some candidates were confused by referring AS-13 on investment accounting.

(c) Only few candidates answered in conformity with requirement of AS-7 on construction contract by mentioning that whole loss of Rs. 0.40 crores should be transferred to profit & loss account as an expense. Many candidates were not aware that when it is probable that total contract costs will exceed total contract revenue the expected loss should be recognized as expenses immediately irrespective of the stage of completion.

(d) The distinction between prior period expenses and change in accounting estimates was not clearly understood by some candidates. Only selected candidates correctly stated that the instant case cannot be considered as prior period expense as there is no error or omission in the earlier period with reference to AS-5.

Question 2. (a) (i) Though many of the answers were correct a few students mentioned that removal of first auditors by share holders without the approval of Central Govt. is invalid.

(a) (ii) Many of the candidates were unaware of the provision of section 77A of the Companies Act, 1956 regarding buy back of shares. Some agreed with the act of the directors of ABC Ltd in buying back of shares with just a special resolution.

Question 2. (b) Though many of the answers were correct, a few students were not aware of clause (e) to subsection 3 of section 226 of the Companies Act, 1956 which substituted the erstwhile clauses by an amendment in 2000.

(c) Some of the answers were general. Some candidates wasted their time in rewriting the question. Only selected candidates pinpointed the weakness of the internal control system in the instant case and measures to overcome the same.

Question 3. (a) Most candidates identified the types of risk but failed to explain properly.

(b) Most candidates explained at length the various rights of C & AG which is not intended by the question. They failed to concentrate on specific right of issuing directions to auditor and doing supplementary audit.

Question 4 (a), (b), (c), & (d) Answers to these questions were general in nature. Many candidates failed to provide exact vouching/Verification requirements. Only a few candidates mentioned the requirement of verifying the FIR in connection with the loss of stock by theft.

Question 5.(a) Some candidates wrote irrelevant answers without mentioning the examples for Accounting estimates as per AAS-18.

(b) Instead of mentioning elements of input control some candidates wrote General EDP controls.

(c) The answers were in general satisfactory.

(d) Only selected candidates mentioned the financial indicators indicating the risk that continuance as going concern may be questionable with reference to AAS-16.

Question 6. The question is specifically on Audit programme on receipt of school fees. Some candidates have written generally on Audit of school run by a charitable Trust. Candidates wrote lengthy answers to topic not relevant like constitution, trust deed, minute book, fixed assets, taxation, expenditure of the school etc., resulting in less weightage given to topic on audit programme on receipt of school fees.

Question 7. (a) Many candidates answered the meaning of qualified Audit Report satisfactorily. However circumstances in which a qualified audit report is issued have been mentioned only by selected candidates with reference to AAS-28.

(b) The answers were in general satisfactory. Some candidates failed to mention the applicability of CARO 2003 to foreign companies as defined in Sec 591 of the Companies Act. Some candidates have not mentioned correctly the conditions stipulated to private company for which CARO-2003 is not applicable.

Question 8. (a) The answers were in general satisfactory. Some candidates were not able to identify all the three fundamental accounting assumptions.

(b) The answers were in general satisfactory. Some candidates failed to give examples.

(c) Many candidates wrote elaborately on audit Evidence. Some candidates failed to mention the meaning of sufficiency and appropriateness of audit evidence as defined in AAS-5.

(d) Though the answers were in general satisfactory only few candidates highlighted the provisions of the Companies Act securing the Independence of Auditors.

PAPER – 3 : BUSINESS AND CORPORATE LAWS

General Comments

The performance in general was 'average'. Candidates lacked in

- writing skills
- knowledge of English
- presentation of answers in accordance with the relevant provisions of various laws.

Specific Comments

Question 1. The overall performance was satisfactory except to the sub-question (a) and (d). Candidates should give reasons to their answers and support it with reference to sections.

Question 2. Majority of the candidates were not familiar with the concept of bailment and its practical application. The circumstances under which the Registrar of Societies may cancel registration of a society under the Cooperative Societies Act, 1912 could not be listed correctly by many candidates.

Question 3. The answer to question on claim of damages under the Indian Contract Act, 1872 was sketchy and most of the candidates did not cite the relevant case law. i.e. Hadley v Baxendale. Very few understood and solved the problem on the Implied Authority of Partners based on the Indian Partnership Act, 1932.

Question 4. The performance to both parts of the question was satisfactory.

Question 5. The performance was unsatisfactory. Candidates lacked knowledge of the provisions relating to Negotiable Instruments Act, 1881 and the Multi-State Co-operative Soceities Act, 2002.

Question 6. Most of the candidates solved the problem based on the Payment of Bonus Act, 1965 and answer relating to the question on the grounds on which a member of a society registered under the Multi State Cooperative Societies Act, 2002 may be expelled from the membership of the Society was more sketchy.

Question 7. The problem based on ultra vires transaction was attempted by many candidates but did not refer to the case law i.e Ashbury Railway Carriage Company vs. Richee. The performance to other parts of the questions on company law was average.

Question 8. The question on Service of Documents under the Companies Act, 1956 was attempted by a very few.

Question 9. The problem based on Section 35 of the Companies Act, 1956 was solved by a very few. ie, the validity of the Certificate of Registration which was given based on the document on which the signatures to the Memorandum of Association were forged.

Question 10. Most of the candidates failed to bring out the relevance of section 173 of the Companies Act, 1956 in relation to annexing an Explanatory Statement to every notice for a meeting of the company at which some special business is to be transacted. Signing of minutes and the period within which it is to be signed by a Director was not known to majority of the candidates.

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